SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1924

No. 129

CHARLES V. DUFFY, COLLECTOR OF INTERNAL REVENUE FOR THE UNITED STATES FOR THE FIFTH DISTRICT OF NEW JERSEY, PETITIONER,

vs.

THE CENTRAL RAILROAD COMPANY OF NEW JERSEY

ON A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

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1 In United States District Court, District of New Jersey

CENTRAL RAILROAD COMPANY OF NEW JERSEY
vs.
CHARLES V. DUFFY, COLLECTOR OF INTERNAL Revenue of the United States for the Fifth District of New Jersey. } At Law.

Docket entries

1920.
June 19. Summons issued.
July 6. Summons and complaint returned, served July 1, and filed.
Aug. 3. Stipulation extending time to answer filed.
" 31. Stipulation extending time to answer filed.
Oct. 26. Answer filed.
1921.
Jan. 4. Notice of trial filed.
Mar. 23. Notice of trial filed.
Apr. 4. Continued for January term.
Aug. 10. Notice of trial filed.
Sep. 12. Continued for April term.
Oct. 17. Notice of trial filed.
Nov. 1. Continued for September term.
1922.
Jan. 4. Notice of trial filed.
" 16. Continued for November term.
Mar. 3. Agreed statement of facts filed.
Mar. 17. Notice of trial field.
2 Apr. 5. Trial before the court. Decision reserved.
" 12. Finding of facts filed.
Apr. 12. Rule for judgment final for plaintiff for $91,812.66 and costs filed.
" 24. Plaintiff's costs taxed at $24.71 and filed.
June 16. Certificate of probable cause filed.
July 20. Assignment of errors filed.
" " Petition for writ of error filed.
" " Order allowing writ of error filed.
" " Citation issued.
" 25. Citation returned, service acknowledged. Copy filed.
" 20. Writ of error issued. Copy filed.

3 In United States District Court

Summons and sheriff's return. Filed July 6, 1920

UNITED STATES OF AMERICA,
District of New Jersey, ss:

The President of the United States of America to Charles V. Duffy, Collector of Internal Revenue of the United States for the Fifth District of New Jersey:

You are summoned to answer the annexed complaint of the Central Railroad Company of New Jersey in an action at law in the District Court of the United States for the District of New Jersey. And take notice that unless you file your answer to said complaint with the clerk of the District Court of the United States for the District of New Jersey, at Trenton, within twenty days after service upon you of this writ and the annexed complaint, the plaintiff may proceed in the suit and judgment may be entered against you.

Witness the Honorable John Rellstab, judge of said court, at Trenton, this 19th day of June, A. D. nineteen hundred and twenty.

[SEAL.] GEORGE T. CRANMER, *Clerk*,
By R. S. CHEVRIER, *Deputy*.

Served the within summons and complaint upon Charles V. Duffy by delivering to and leaving with Eugene Wilkham (chief clerk) a copy thereof at Newark, in the District of New Jersey, on the 1st day of July, 1920, and at the same time showing him this original with the seal of the court attached and informing him of its contents.

ALBERT BOLLSCHWEILLER,
United States Marshal,
By HARRY S. PROVOST, *Deputy*.

4 In United States District Court

Complaint

[Title omitted.]

To the honorable the judges of the District Court of the United States for the District of New Jersey:

Plaintiff complains of defendant and respectfully represents and says that:

1. Plaintiff is a corporation duly organized and existing under and in accordance with the laws of the State of New Jersey and having its principal office and place of business at Central Railroad Terminal in the city of Jersey City, in the county of Hudson, in the State of New Jersey.

2. Defendant is and was and has been at all times herein mentioned the collector of internal revenue of the United States for the

Fifth District of New Jersey, having his office and official place of residence at Newark, in the county of Essex, in the State of New Jersey.

3. Prior to and on July 15, 1917, defendant, claiming to act as collector as aforesaid, represented to plaintiff that there was lawfully due to the United States and to him as such collector, from defendant, the sum of $152,621.31, claiming and representing that said sum had been lawfully assessed against plaintiff, under
5 and in accordance with Part II of Title I of the act of Congress of September 8, 1916 (39 Stat. 765). And on said June 15, 1917, and prior thereto, defendant demanded that plaintiff pay said sum and every part thereof to defendant, and threatened plaintiff with distraint and with penalties and forfeitures in case such payment should be refused. Wherefore, on said June 15, 1917, but under duress and with protest and to avoid penalties threatened by the defendant, plaintiff paid to defendant, involuntarily and insisting that plaintiff was not lawfully required to make said payment or any part thereof, said sum of $152,621.31.

4. The actual net income of plaintiff for the year which ended with December 31, 1916, in respect of which defendant was lawfully entitled on said June 15, 1917, to demand and to receive payment of a tax at the rate of two per centum of said net income, as provided in said Part II of said Title I of said act, was $4,030,554.45 and no more. Defendant unlawfully added to said $4,030,554.45, the sum of $3,600,511.20, which said addition of $3,600,511.20 was effected by adding to the actual gross income of plaintiff the sum of $1,675,-580.60, which was the amount of certain expenditures made by plaintiff during said year in accordance with certain leases in which the plaintiff is lessee and by also excluding from the lawful deductions from said gross income said sum of $1,675,580.60, all which was expended under said leases in order to retain possession of the leased property and for no other purpose and by also excluding from said lawful deductions the further sum of $249,350.00, which was expended by plaintiffs during said year in order to retain possession of property affected by a mortgage, said $249,350.00 being the interest on the bonds secured by said mortgage. By reason of said unlawful addition to said net income, defendent claimed and exacted said sum of $152,621.31, which was $72,010.22 in excess of the amount of $80,611.09 which defendant, as collector as aforesaid, was lawfully entitled to demand and to receive.

6 5. On or about March 8, 1918, plaintiff duly appealed to the Commissioner of Internal Revenue from and on account of the aforesaid action of defendant and represented to said commissioner that the collection of said $72,010.22, being part of said $152,621.31, was unlawful and claimed and demanded that said sum of $72,010.22 and each and every part thereof should be refunded. No decision upon said appeal has been had or made by said commissioner and such decision has been delayed more than six months from the date of such appeal. No part of said $72,010.22 has been

repaid or refunded to plaintiff by defendant or otherwise and defendant has refused and continues to refuse to repay said $72,010.22 or any part thereof.

6. Plaintiff demands judgment against defendant for $72,010.22, with interest from said June 15, 1917.

WM. A. BARKALOW,
Attorney for Plaintiff.

H. T. NEWCOMB,
Of Counsel.

7 In United States District Court

[Title omitted.]

Answer. Filed October 26, 1920

Defendant, Charles V. Duffy, appearing herein by Elmer H. Geran, United States attorney for the District of New Jersey, answering the complaint of the plaintiff herein, says:

1. Defendant admits the allegations of paragraph 1 of the complaint.

2. Defendant admits the allegations of paragraph 2 of the complaint.

3. Defendant has not sufficient knowledge or information to form a belief as to the allegations of paragraph 3 of the complaint.

4. Defendant denies paragraph 4 of the complaint.

5. Defendant has not sufficient knowledge or information to form a belief as to the allegations of paragraph 5 of the complaint.

6. Defendant denies that plaintiff is entitled to judgment for $72,010.22, with interest from June 15, 1917.

ELMER H. GERAN,
United States Attorney, District of New Jersey.

8 In United States District Court

[Title omitted.]

Agreed statement of facts. Filed March 3, 1920

The above-named plaintiff, by William A. Barkalow, its attorney, and the above-named defendant, by Elmer H. Geran, United States district attorney for the District of New Jersey, his attorney, hereby stipulate and agree that the following is a statement of all the facts upon which this action depends and that this action shall be submitted to the court for its determination upon this statement of facts, trial by a jury being hereby expressly waived:

1. Plaintiff is, and during the year 1916 was, a corporation, duly organized and existing under and by virtue of the laws of the State

of New Jersey, having its principal office and place of business in the city of Jersey City, in the county of Hudson and State of New Jersey.

2. Defendant is, and during the year 1916 was, the collector of internal revenue of the United States for the Fifth District of New Jersey.

3. During the year 1916 plaintiff was subject to the provisions of Part 2 of Title I of the act of Congress of September 8, 1916, entitled "An act to increase the revenue and for other purposes" (39 Statutes at Large, 765).

4. Plaintiff's gross income for the calendar year ended December 31, 1916, was as follows:

From operations	$34,372,348.34
From rentals	722,375.91
From interest	377,653.06
From dividends	202,448.09
From other sources	179,566.63
Total gross income	35,854,392.03

5. Under and by virtue of the aforesaid act of Congress, plaintiff was entitled to deduct from its aforesaid gross income the following amounts:

Expenses	$23,994,443.95
Loss sustained charged off	225,584.41
Depreciation charged off	1,720,009.95
Interest	2,225,091.67
Taxes, domestic	1,947,273.70
Total	30,112,403.68

6. In addition to said amount of $30,112,403.68, plaintiff expended, under the circumstances hereinafter set forth, during said calendar year 1916, the following amounts:

A. *For additions and betterments to Lehigh and Susquehanna Railroad and branches, $103,496.68*

During the calendar year 1916 plaintiff was in possession of the Lehigh and Susquehanna Railroad and branches, extending generally from Phillipsburg, in the State of New Jersey, to Union Junction, Luzerne County, Pennsylvania, under a lease from the Lehigh Coal and Navigation Company, its owner, dated March 31,
10 1871, as modified by agreements dated May 29, 1883, and June 28, 1887, the provisions of which agreements, so far as they are pertinent to this cause, are as follows:

The term of the lease begins from and after April 1, 1871, and runs for and during the continuance of the charters of the parties thereto and for any renewals of the same, excepting that, as to the Nesquehoning Railroad, one of the branches of the Lehigh and Susquehanna Railroad, it is not to extend beyond the term of nine hundred and ninety-nine years from the 4th of November, 1868,

less one day. The charters of both parties to said agreement are perpetual, but are subject to alteration or repeal by the Legislatures of the States of New Jersey and Pennsylvania, under which States said companies were respectively incorporated.

Under said lease plaintiff is required to well and efficiently operate said railroad and all such extensions and additions as may be made thereto, at its own cost and risk, and to pay to the lessor, for the use of the same, one-third of the gross receipts from the traffic or business of the said railroad and of the extensions thereof and additions thereto, subject to a maximum payment of $2,043,000 and a minimum payment of $1,414,400. Plaintiff is also required to maintain and perpetuate said railroad and branches and to keep and maintain the same in good order and repair and fit for efficient use at its own cost and charges, and to so return and deliver up the demised premises at the termination of the lease, the lease stating that it is the true intent and meaning thereof that the demised premises shall be so worked and maintained by plaintiff as to secure the largest amount of revenue possible therefrom.

In addition, said lease provides that all railroads or rail-
11 ways, with their branches, extensions, sidings, and buildings connected therewith, etc., shall, when and as the same are constructed, become part of the demised premises.

It also contains a provision that, in case of any breach of covenant on the part of the lessee, the lessor may terminate the lease unless the lessee makes compensation within a reasonable time after notice from the lessor.

Said sum of $103,496.68 was expended by plaintiff during the calendar year 1916 for additions and betterments necessary to maintain and perpetuate said Lehigh and Susquehanna Railroad and branches and to keep and maintain the same in good order and repair and fit for efficient use, under the terms of the said lease.

B. *For additions and betterments to Wilkes-Barre and Scranton Railroad, $2,507.35*

During the calendar year 1916 plaintiff was in possession of the Wilkes-Barre and Scranton Railroad, extending from a point called Minooka Junction, in Lackawanna County, Pennsylvania, to a point near Lackawanna Avenue, in the city of Scranton, as assignee of a lease from the Wilkes-Barre and Scranton Railroad to the Lehigh Coal and Navigation Company, dated May 1, 1888, the provisions of which lease and assignment, so far as they are pertinent to this cause, are as follows:

The term of the lease begins from and after the date thereof and runs from and during the continuance of the charter of the Wilkes-Barre and Scranton Railway Company, less one year, said charter being perpetual but subject to alteration and repeal by the Legislature of the State of Pennsylvania.

Under said lease and assignment plaintiff is required to well
12 and efficiently operate said railroad and all such extensions and additions as may be made thereto, at its own cost and risk, and to pay for the use of the same a monthly rental, which shall be equal to one-twelfth of six per cent on the cost of the demised premises as the same appears on the books of the lessor, plus all taxes, both on the demised premises and on the rent or revenue of the Wilkes-Barre and Scranton Railway Company. Plaintiff is also required to maintain and perpetuate said railroad and to keep and maintain the same in good order and repair and fit for efficient use, at its own cost and charges, and to so return and redeliver up the same at the termination of the lease, the lease stating that it is the true intent and meaning thereof that the demised premises shall be so worked and maintained by plaintiff as to secure the largest amount of revenue possible therefrom.

In addition, said lease provides that in case of any breach of covenant on the part of the lessee, its successors and assigns, and notice thereof given by the lessor, if the same cannot or shall not be fully compensated within a reasonable time thereafter, the lessor may, at its option, declare the lease to be terminated, and thereupon enter upon the property and premises as and for condition broken, and repossess itself thereof as of its old and former estate.

It is provided by the assignment that if, for any reason, the lease of the Lehigh and Susquehanna Railroad, referred to in "A" above, shall be terminated and said railroad shall revert to the Lehigh Coal and Navigation Company or its assigns, the possession and control of the Wikes-Barre and Scranton Railroad by plaintiff and the term of the contract for the possession of the same shall terminate, and it also shall revert to the Lehigh Coal and Navigation Company.

13 Said sum of $2,507.35 was expended by plaintiff during the calendar year 1916 for additions and betterments necessary to maintain and perpetuate said Wilkes-Barre and Scranton Railroad and to keep and maintain the same in good order and repair and fit for efficient use, under the terms of the aforesaid lease and assignment.

C. *For additions and betterments to Allentown Terminal Railroad, $232.31*

During the calendar year 1916, plaintiff was in possession, as tenant in common with the Philadelphia and Reading Railway Company, of the Allentown Terminal Railroad, located in the city of Allentown, Pennsylvania, and connecting with the Lehigh and Susquehanna Railroad and the Philadelphia and Reading Railway at that point, as assignee of the interest of the Lehigh Coal and Navigation Company under a lease from the Allentown Terminal Railroad Company, its owner, dated July 10, 1889, the provisions of which lease and assignment, so far as they are pertinent to this cause, are as follows:

The term of the lease begins from and after July 10, 1889, and runs for and during the term of nine hundred and ninety-nine years.

Under said lease, the lessees are required to keep and maintain said railroad and its appurtenances in good working order, and to return the same in equally good order to the lessor at the expiration of the lease, and to pay to the lessor for the use of the same the sum of $40,500 per year as rent. The lessees are also required to pay the cost of all permanent improvements which may be necessary or convenient for the operation, use or enjoyment of said railroad.

14 Under said lease and assignment, plaintiff is required to pay two-thirds of the rent, the cost of maintenance and the cost of permanent improvements, while its co-tenant is required to pay one-third thereof.

Under the terms of the said assignment, the interest of the plaintiff in said lease is to terminate upon the termination of the lease of the Lehigh and Susquehanna Railroad, referred to in "A" above.

Said sum of $232.31 was expended by plaintiff during the calendar year 1916 as its share of the cost of additions and betterments to said Allentown Railroad which were necessary for the operation and maintenance of said railroad in good working order.

D. *For additions and betterments to the Ogden Mine Railroad, $855.22*

During the calendar year 1916, plaintiff was in possession of the Ogden Mine Railroad, extending generally from Ogden mine, in the township of Sparta, Sussex County, New Jersey, to Nolan's Point, on Lake Hopatcong, in Dover Township, Morris Counyt, New Jersey, under a lease from the Ogden Mine Railroad Company, its owner, dated November 4, 1881, hte provisions of which so far as they are pertinent to this cause, are as follows:

The term of said lease is for nine hundred and ninety-nine years from the first day of January, 1882.

Under said lease, plaintiff is required to at all times maintain and keep said railroad and all its appurtenances in good repair and condition and in all respects fit for use as a railroad, and to use and operate the same as a railroad in accordance with the charter of the lessor, paying to the lessor, for the use of the same, a yearly rent of $22,500.

15 The lease contains a provision that if the plaintiff shall make default in the payment of the rent or shall fail to perform any of the covenants contained in the lease, within a reasonable time after request in writing so to do, then the lease may be terminated and declared forfeited and at an end, and the lessor may re-enter upon and repossess itself of the whole of said railroad.

Said sum of $855.22 was expended by plaintiff during the calendar year 1916 for additions and betterments to said railroad necessary to maintain and keep the same in good repair and condition and in all respects fit for use as a railroad.

E. *For additions and betterments to Dover and Rockaway Railroad, $6,967.23*

During the calendar year 1916, plaintiff was in possession of the Dover and Rockaway Railroad, extending from Port Oram, Morris County, New Jersey, to a point near Rockaway, Morris County, New Jersey, as successor to the interest of the Longwood Valley Railroad Company under a lease of said Dover and Rockaway Railroad to said Longwood Valley Railroad Company, dated April 26, 1881, as the result of the merger of said Longwood Valley Railroad Company with plaintiff on December 30, 1887. The provisions of said lease, so far as they are pertinent to this cause, are as follows:

The term of the lease runs for nine hundred and ninety-nine years from April 1, 1881. Under it plaintiff is required at all times to maintain and keep the said railroad and all its appurtenances in good repair and condition and in all respects fit for use as a railroad, and to use and operate the same as a railroad in accordance with the laws of New Jersey. Plaintiff is required
16 to pay rent, dividends at the rate of six per cent on the outstanding capital stock of the Dover and Rockaway Railroad Company, interest on its bonded indebtedness, and taxes assessed upon its property, franchises, earnings, traffic, and business, as well as the cost of maintaining its corporate existence.

The lease further provides that if plaintiff shall make default in the payment of the rent reserved by said lease, or in any of the payments therein covenanted to be made by it for a period of thirty days after the same shall have become due and shall have been demanded from it in writing, or shall fail to perform any of the other covenants in said lease on its part to be performed within a reasonable time after a request in writing to perform the same, the lessor may declare the lease forfeited and at an end, and re-enter upon and repossess itself of the whole of the demised premises.

Said sum of $6,967.23 was expended by plaintiff during the calendar year 1916 for additions and betterments to said Dover and Rockaway Railroad necessary to maintain and keep said railroad and its appurtenances in good repair and condition and fit for use as a railroad under the terms of the aforesaid lease.

F. *For construction of Pier (new) 9 and bulkhead, near the foot of Carlisle Street, New York, $1,525,308.72*

During the calendar year 1916, plaintiff was in possession of Pier (new) 9, near the foot of Carlisle Street, in the city of New York, as assignee of that portion of a lease made by the city of New York with the Lehigh Valley Railroad Company, dated January 13, 1914, as modified by a supplemental agreement dated March 14, 1914, covering Pier (new) 9. Under this lease, the city of New
17 York leased a plot of land under water near the foot of Carlisle Street, known as Pier (new) 9. The city agreed to condemn all the right, title, and intreest of private owners in Pier (old)

9 and in the bulkhead. Plaintiff agreed to defray the entire cost of such condemnation, including awards, fees of commissioners and experts, and all other necessary disbursements.

On the vesting of title in the city of New York of such property, the plaintiff agreed to at once proceed with the improvement of the waterfront, including the building of Pier (new) 9, a stone bulkhead wall and sheds on said pier and upon the marginal street, wharf or place extending inshore a distance of fifty feet from the bulkhead, including the filling in in the rear of the bulkhead and the paving of the marginal street, wharf or place extending from the bulkhead line inshore to the westerly line of West Street in the city of New York, in accordance with plans, specifications and estimates of cost approved by the engineer of the Department of Docks and Ferries of the city of New York.

Under said lease, plaintiff agreed to pay rent at the rate of 27½ cents per square foot per annum for the portion of the demised area not acquired from private owners and the sum of $1.00 per year for the property so acquired from private owners. The lease further provided that if the cost of the improvement—being the entire cost of the condemnation proceeding, including awards, fees of commissioners and experts and all other necessary disbursements taxed in connection therewith, together with the cost of improving the property, including the cost of building Pier (new) 9 and the bulkhead wall and the sheds to be erected on said pier and bulkhead and
18 on the marginal street, wharf or place adjacent thereto, the cost of filling in in the rear of said bulkhead and the paving of the marginal street—should be less than the sum of $2,750,000, plaintiff was to pay annually, in addition to the above amount, an amount which should be 5½ per cent on a sum which should be equal to the difference between the said sum of $2,750,000 and such entire cost; while, if the cost of the improvement should be more than the sum of $2,750,000, the plaintiff was to be credited upon the average annual rental for a term of thirty-nine years with an amount equal to 5½ per cent upon the difference between said cost and the said sum of $2,750,000. It was further provided that, in the event that 5½ per cent on said difference between the cost of said improvement and the sum of $2,750,000 should exceed the average annual rental for the land under water for the term of thirty-nine years, then the term of the lease should be extended for a period which should bear the same proportion to thirty-nine years as the amount of excess cost over the sum of $2,750,000, plus the amount upon which 5½ per cent is equal to the amount of rental for the land over that acquired from private owners should bear to $2,750,000.

The lease also provides that the piers, bulkhead, sheds and other improvements made or erected in accordance with its terms shall revert to and become the property of the city of New York at the expiration or sooner termination thereof. Under it, the plaintiff is required to keep and maintain the premises and the structures

thereon or to be erected thereon in good and sufficient repair and condition, at its own sole cost and expense, and do all painting and dredging.

The term of the lease is for ten years, subject to two re-
19 newals of ten years, and a further renewal of nine years or for such longer period as plaintiff may be entitled to in the event that the cost of the improvements exceed $2,750,000, the rent increasing 10 per cent at each renewal.

Under the lease the city may, at any time after ten years from the commencement thereof, terminate the same, but in case of such termination, the city is to pay such reasonable sum to plaintiff as may be fixed by arbitrators provided for in the lease. The lease also provides that in the event plaintiff fails to pay the rent for a space of ten days, or fails to perform, keep, do or observe any or either of the covenants, agreements, things, terms or conditions of the lease, the city may declare the lease at an end.

During the calendar year 1916, plaintiff expended the sum of $1,525,308.72 for the construction of Pier (new) 9 and bulkhead.

G. *For dredging at Pier 80, North River, $28.72*

During the calendar year 1916, plaintiff was in possession of Pier 80, at the foot of West 40th St., in the city of New York, under a lease from the city of New York dated August 17, 1909. The term of said lease is for ten years plus two renewals of ten years each, the rent during the first term being $18,900 and increasing at each renewal. Under the lease the city has the right to terminate it for plaintiff's failure to pay the rent or to observe the covenants or agreements in the lease.

Under this lease plaintiff is required to do such dredging as may be considered by the Commissioner of Docks of the city of New York necessary and proper to be done in the slips adjacent to said pier, and the city is specifically given the right to terminate the lease
20 upon plaintiff failing to do such dredging for a space of ten days after notice to do the same.

During the calendar year 1916 plaintiff expended for dredging the slip on the north side of Pier 80, N. R., $28.72, which dredging was considered necessary and proper to be done by the Commissioner of Docks of the city of New York.

H. *For dredging at Pier 46, North River, $38.10*

During the calendar year 1916, plaintiff was in possession of Pier 46, N. R., New York, under a lease from the city of New York dated May 19, 1915. The term of said lease is for ten years from October 24, 1914, and the rental is $43,762.95. The city has the right to terminate the lease upon plaintiff's failure to pay the rent reserved or to perform the covenants thereof.

Under said lease plaintiff is required to do such dredging as may be considered by the Commissioner of Docks necessary and proper to be done in the slips adjacent to said pier and the city is specifically given the right to terminate the lease upon plaintiff failing to do such dredging for a space of ten days after notice to do the same.

During the calendar year 1916, plaintiff expended the sum of $38.10 for dredging the slip on the north side of Pier 46, which said dredging was considered by the Commissioner of Docks necessary and proper to be done.

I. *For constructing an extension to Pier 46, North River, $14,486.22*

During the year 1916, plaintiff was in possession of an extension to Pier 46, North River, New York, under a lease from the city of New York, dated May 12, 1916. The term of said lease expires
21 October 25, 1924, and the rental is 27½ cents per square foot per annum for the area of land under water covered by said extension. The city has the right to terminate the lease upon plaintiff's failure to pay the rent reserved or to perform the covenants thereof.

Under this lease plaintiff is required to construct an extension to Pier 46 and a shed thereon under the direction and supervision of the chief engineer of the Department of Docks and Ferries of the city of New York, which revert to and become the property of the city of New York at the expiration or sooner termination of the lease.

During the calendar year 1916 plaintiff expended the sum of $14,486.22 in constructing said extension to Pier 46.

J. *For erection of extension Pier 39, N. R., $6,003.78*

During the year 1916, plaintiff was in possession of an extension to Pier 39, North River, New York, under a lease from the city of New York dated December 30, 1913, which lease granted plaintiff a term of ten years plus one extension of ten years at an annual rental of 27½ cents per square foot for the area of land under water occupied by said extension to said pier. The city has the right to terminate the lease upon plaintiff's failure to pay the rent reserved to perform the covenants thereof.

Under this lease plaintiff is required to build said extension at its own expense, but upon the expiration or sooner termination of the lease said extension is to revert to and become the property of the city of New York.

In accordance with the terms of this lease plaintiff expended during the year 1916 the sum of $6,003.78 for building the extension to Pier 39.

22 A detailed statement of such expenditures for additions and betterments is attached hereto marked "A."

7. If plaintiff is entitled to deduct from its gross income said expenditures amounting to $1,659,924.33 in addition to said deductions amounting to $30,112,403.68, its net income subject to tax under the provisions of the aforesaid act of Congress for the calendar year ended December 31, 1916, was $4,082,064.02, upon which amount the tax under the aforesaid act amounts to $81,641.28.

8. If plaintiff is not entitled to deduct said expenditures amounting to $1,659,924.33 in addition to said deductions amounting to $30,112,403.68, its net income assessable under the aforesaid act of Congress for the calendar year ended December 31, 1916, amounted to $5,741,988.35, upon which the tax provided by said act of Congress amounts to $114,839.77.

9. Defendant, as collector of internal revenue for the Fifth District of New Jersey, assessed the sum of $152,621.31 as taxes on plaintiff's income for the calendar year ended December 31, 1916.

10. Plaintiff paid to defendant said sum of $152,621.31, assessed as taxes on its income for the calendar year ended December 31, 1916, under duress and with protest and to avoid penalties threatened by the defendant, and said payment was not voluntarily made.

11. On March 8, 1918, plaintiff duly appealed to the Commissioner of Internal revenue from and on account of said assessment of $152,-621.31, and represented and claimed that $72,010.22 thereof was unlawful and should be refunded. No decision upon said appeal has been had or made by said commissioner, and such decision has been delayed more than six months from date of such appeal, and no part of said $72,010.22 has been repaid or refunded to
23 plaintiff; although on a computation later made said claim is now in reality for the sum of $70,980.03, instead of $72,-010.22, as originally claimed.

WM. A. BARKALOW,
Attorney for plaintiff.

ELMER H. GERAN,
United States Attorney, Attorney for Defendant,
By FREDERIC M. P. PEARSE,
Assistant United States Attorney.

Exhibit "A" to agreed statement of facts

Detailed statement of expenditures referred to in paragraph 6 of agreed statement of facts:

A. Additions and betterments to Lehigh & Susquehanna Railroad and branches:	
Renewing span, bridge 95, Wilkes-Barre	*$110.10*
Increase weight rail	34,625.56
Improved track material	1,533.03
Renewing west portion tunnel, White Haven	3,396.79
Additional & relocation tracks at Hope	524.50
Renewing bridge #4, Easton	*15,786.09*
Viaduct, Butler St., Wilkes-Barre	6,452.29
Renewing bridge #93, Ashley	12,178.36
Connecting up tracks in yard, Penobscot	68.86

A. Additions and betterments to Lehigh & Susquehanna Railroad and branches—Continued.		
	Siding for coal storage, Ashley	$774.48
	Additional yard tracks, Ashley	31,665.10
	Two signals on "hump," Allentown yard	109.27
	Changing signals on L. & S. Div	*34.17*
	Road crossing bell, Lehigh Gap	*117.62*
	Renewing flagging on leased property	112.51
	Extension siding, Northampton	195.28
	Telephone, Allentown yard	165.07
24	Coal storage near Nesquehoning	*698.41*
	Road crossing bell, Parsons	1,991.41
	Siding for Easton Merchanst Ice Co	8.83
	Rearrangement tracks for New Jersey Zinc Co	*95.62*
	Crossing bells, Northampton	10.08
	Tracks at Empire colliery, Wilkes-Barre	*94.70*
	Extension tool house, Walnutport	114.52
	Bell at public crossing, Lehigh Gap	1,068.81
	Telegraph line, Allentown yard	151.68
	Extension trainmen's building, Bethlehem Jct	351.58
	Siding for F. F. Jones & Son, Nanticoke	*69.84*
	Crossing bells, Catasauqua	92.82
	Yard tracks, Bethlehem Jct	4,583.12
	Renewing bridge 14, Ashley	200.00
	Bunk house, Bethlehem	648.87
	Additional track, Siegfried	1,618.96
	Alterations freight house, Easton	640.25
	Indicators, Miners Mill	314.63
	Relocation portion Cemetery St., Ashley	295.88
	Team track, Blackman St., Ashley	191.86
	Siding for Gerber Engineering Co., Beth. Jct	271.87
	Rest room for trainmen, Allentown	51.01
	Replacement train order signals, L. & S. Div	60.76
	Increase water supply facilities, Allentown yard	9,615.27
	Automatic signals, Newport St., Ashley	856.03
	Siding removed at tunnel	*306.10*
	Tracks for Lehigh & Wilkes-Barre Coal Co., Wanamie	3,636.90
	Siding for Faust Lubricating Co., Lee	*15.61*
	Crossover from siding to main track, Glendon	2,259.49
	Installing telephone line shop, Ashley	117.71
	Crossing bells, Park Ave., Wilkes-Barre	101.38
	Siding for Alliance Cement Block Co., Palmerton	22.17
	Extension gas siding, Bethlehem	238.09
25	Additional track, Nesquehoning Jct	1,058.82
	Total	$103,496.68
B. Additions and betterments to Wilkes-Barre and Scranton Railroad:		
	Renewing bridge 60, Scranton	$10.85
	Passenger station, retaining wall, etc., Scranton	1,833.88
	Increase weight rail	662.62
	Total	$2,507.35
C. Additions and betterments to Allentown Railroad:		
	Improved track material	*22.51*
	Interchange tracks L. V. R. R., Allentown	457.11
	Siding for M. J. Egan	50.75
	Rest house for dining car crew, Allentown	23.60
	Rearrangement tracks, station	1.50
	Rearrangement tracks, West End Terminal	*2,889.89*
	Additional term delivery tracks, Allentown	*161.88*
	Resetting curb & paving, 3rd St., Allentown	*27.50*
	Land at Allentown	2,801.13
	Total	$232.31

NOTE.—Figures in italic are in red ink in copy.

D. Additions and betterments to Ogden Mine Railroad:	
Telephone despatching system, Ogden Mine R. R	$182.23
Land at Lake Hopatcong	672.99
Total	$855.22
26 E. Additions and betterments to Dover & Rockaway Railroad:	
Telephone despatching system, Dover & Rockaway R. R	1,244.01
Renewing bridge 278, Dover	4,881.27
Increase weight rail	84.37
Improved track material	68.80
Siding for N. J. Power & Electric Light Co., Dover	688.78
Total	$6,967.23
F. J. Piers, New York City:	
New Pier 9 and bulkhead	1,525,308.72
Dredging north side Pier 80	28.72
" " " " 46	38.10
Extension to Pier 46	14,486.22
Extension Pier 39	6,003.78
Total	$1,545,865.54

27 In United States District Court

[Title omitted.]

Finding of Facts. Filed April 12, 1922

The court finds the following facts:

1. That plaintiff is and was a corporation organized and existing under the laws of New Jersey and that the defendant is and was the collector of internal revenue of the United States for the Fifth District of New Jersey, as set up in paragraphs 1 and 2 of the agreed statement of facts.

Defendant's counsel prays an exception to the court's finding and an exception is allowed and sealed accordingly.

J. L. BODINE, *Judge.*

2. That plaintiff's gross income for the calendar year ended December 31, 1916, was $35,854,392.03.

Defendant's counsel prays an exception to the court's finding and an exception is allowed and sealed accordingly.

J. L. BODINE, *Judge.*

28 3. That under and by virtue of the act of Congress entitled "An act to increase the revenue and for other purposes," approved September 8, 1916, plaintiff was entitled to deduct from its gross income $30,112,403.68.

Defendant's counsel prays an exception to the court's finding and an exception is allowed and sealed accordingly.

J. L. BODINE, *Judge.*

4. That within the year 1916 plaintiff expended the amounts, aggregating $1,659,924.33, mentioned in paragraph 6 of the agreed

statement of facts, for the purposes and under the circumstances therein mentioned.

Defendant's counsel prays an exception to the court's finding and an exception is allowed and sealed accordingly.

J. L. BODINE, *Judge.*

5. That the amount mentioned in paragraph 6 of the agreed statement of facts, and each of them, were rentals or other payments required to be made as a condition to the continued use or possession of property to which plaintiff had not taken or was not taking title.

Defendant's counsel prays an exception to the court's finding and an exception is allowed and sealed accordingly.

J. L. BODINE, *Judge.*

6. That within the calendar year ended December 31, 1916, plaintiff was required to expend and expended the sum of $1,659,924.33 as a condition to the continued use or possession of property to which it had not taken or was not taking title, which sum is not included in the deductions aggregating $30,112,403.68 mentioned in paragraph 3.

29 Defendant's counsel prays an exception to the court's finding and an exception is allowed and sealed accordingly.

J. L. BODINE, *Judge.*

7. That plaintiff is entiled to deduct from its gross income for calendar year ended December 31, 1916, said expenditures amounting to $1,659,924.33 in addition to said deductions amounting to $30,112,403.68.

Defendant's counsel prays an exception to the court's finding and an exception is allowed and sealed accordingly.

J. L. BODINE, *Judge.*

8. The plaintiff's net income subject to tax under the provisions of the aforesaid act of Congress for the calendar year ended December 31, 1916, was $4,082,064.02.

Defendant's counsel prays an exception to the court's finding and an exception is allowed and sealed accordingly.

J. L. BODINE, *Judge.*

9. That defendant as collector of internal revenue for the Fifth District of New Jersey, assessed the sum of $152,621.31 as taxes on plaintiff's income for the calendar year ended December 31, 1916, which amount plaintiff paid to the defendant on June 15, 1917, under duress and with protest and to avoid penalties threatened by the defendant and said payment was not voluntarily made.

Defendant's counsel prays an exception to the court's finding and an exception is allowed and sealed accordingly.

J. L. BODINE, *Judge.*

10. That on March 8, 1919, plaintiff duly appealed to the Commissioner of Internal Revenue from and on account of said assess-

ment of $152,621.31 and represented and claimed that
30 $72,010.22 thereof was unlawful and should be refunded and that no decision upon said appeal has been had or made by said commissioner and that such decision was delayed more than six months from the date of said appeal prior to the institution of this suit.

Defendant's counsel prays an exception to the court's finding and an exception is allowed and sealed accordingly.

J. L. BODINE, *Judge.*

11. That the tax so assessed by defendant against plaintiff and paid by it on its income for the calendar year ended December 31, 1916, exceeded the tax lawfully due by $70,980.03.

Defendant's counsel prays an exception to the court's finding and an exception is allowed and sealed accordingly.

J. L. BODINE, *Judge.*

12. That plaintiff is entiled to judgment against the defendant for said sum of $70,980.03, together with interest thereon at 6 per cent from June 15, 1917.

Defendant's counsel prays an exception to the court's finding and an exception is allowed and sealed accordingly.

J. L. BODINE, *Judge.*

31 In United States District Court

[Title omitted.]

Judgment. Filed April 12, 1922

This cause being regularly on the list for trial at the April term, 1922, of this court and both parties, by consent in writing duly filed with the clerk of this court, having waived trial by jury and consented that the issues be tried by the court, and the cause being called on April 5, 1922, and the plaintiff appearing by Charles E. Miller, its counsel, and the defendant appearing by Frederic M. P. Pearse, his counsel, and the parties having submitted the cause to the court upon an agreed statement of facts and the court having found that the plaintiff is entitled to judgment against the defendant in the sum of $70,980.03, together with interest thereon at the rate of 6 per cent from June 15, 1917;

It is thereon upon this 12th day of April, 1922,

Ordered, that judgment final be entered against said defendant and in favor of said plaintiff in the sum of ninety-one thou-
32 sand eight hundred and twelve dollars and sixty-six cents ($91,812.66), and that said plaintiff recover the costs of this suit to be taxed.

J. L. BODINE, *Judge.*

On motion of
CHARLES E. MILLER,
Of Counsel for Plaintiff.

33 In United States District Court

[Title omitted.]

Petition for and order allowing writ of error. Filed July 20, 1922

To the honorable judges of the United States District Court for the District of New Jersey:

And now comes Charles V. Duffy, former collector of internal revenue of the United States for the Fifth District of New Jersey, defendant in the above-entitled cause, by Walter G. Winne, United States attorney for the District of New Jersey, and Frederic M. P. Pearse, assistant United States attorney, and says that on the 12th day of April, 1922, the court entered judgment herein against defendant (said cause having been tried before the court without a jury on an agreed statement of facts) for the sum of ninety-one thousand eight hundred twelve dollars and sixty-six cents ($91,812.66), in which final judgment and the proceedings had prior thereunto in this cause certain errors were committed to the prejudice of this defendant, all of which will more fully appear in the assignment of errors which is filed with this petition.

34 Wherefore the defendant prays that a writ of error may issue in this behalf to the United States Circuit Court of Appeals for the Third Circuit for the correction of the errors so complained of and that a transcript of the record of the proceeding and papers in this cause duly authenticated may be sent to the said court.

WALTER G. WINNE,
United States Attorney.
FREDERIC M. P. PEARSE,
Asst. U. S. Attorney.
Attorneys for the Defendant, (Plaintiff-in-Error.)

35 [Title omitted.]

This 20th day of July, 1922, came the defendant, Charles V. Duffy, former collector of internal revenue of the United States for the Fifth District of New Jersey, by Frederic M. P. Pearse, assistant United States attorney, and filed herein and presented to the court its petition praying for the allowance of a writ of error intended to be urged by him; praying also that the transcript of record and proceedings and papers, upon which the judgment herein was rendered, duly authenticated, may be sent to the United States Circuit Court of Appeals for the Third Circuit, and that such other and further proceedings may be had as may be proper in the premises.

On consideration whereof the court has allowed the writ of error.

J. L. BODINE, *Judge.*

36 In United States District Court

[Title omitted.]

Assignments of error. Filed July 20, 1922

And said Charles V. Duffy, collector of internal revenue of the United States for the Fifth District of New Jersey, defendant and plaintiff-in-error, by Walter G. Winne, United States attorney, and Frederic M. P. Pearse, assistant United States attorney, comes and says that in the record and proceedings and also in the matter contained in the bill of exceptions and in the refusal of the court to find the facts as requested by the defendant in said cause by the said District Court of the United States for the District of New Jersey, there is manifest error in this, to wit:

1. The court erred in rendering final judgment for the plaintiff instead of for the defendant.

2. The conclusions of the court on the findings of fact should have been in favor of the defendant instead of in favor of the plaintiff.

37 3. The court erred on the conclusions of law in finding for and allowing a final judgment to be entered in favor of the plaintiff instead of the defendant.

4. The agreed statement of facts shows that plaintiff had no cause of action and that final judgment should have been entered in favor of the defendant instead of in favor of the plaintiff.

WALTER G. WINNE,
United States Attorney.
FREDERIC M. P. PEARSE,
Asst. U. S. Atttorney.
Attorneys for the Defendant, (Plaintiff-in-Error.)

38 In the United States Circuit Court of Appeals for the Third Circuit, October Term, 1922

CHARLES V. DUFFY, COLLECTOR, PLAINTIFF in error,
vs.
CENTRAL RAILROAD OF NEW JERSEY, DEFENDANT in error.
No. 2925.

Argument and submission

And afterwards, to wit, this 15th day of December, 1922, come the parties aforesaid by their counsel aforesaid, and this case being called for argument sur pleadings and briefs, before the Honorable Joseph Buffington, Honorable Victor B. Woolley, and Honorable J. Warren Davis, circuit judges, and the court not being fully ad-

vised in the premises, takes further time for the consideration thereof.

And afterwards, to wit, on the third day of May, 1923, come the parties aforesaid by their counsel aforesaid, and the court, now being fully advised in the premises, renders the following decision:

39 In the United States Circuit Court of Appeals

[Title omitted.]

Opinion. Filed May 3, 1923

Before Buffington, Woolley, and Davis, Circuit Judges.

DAVIS, Circuit Judge:

This action was instituted by the Central Railroad Company of New Jersey against Charles V. Duffy, collector of internal revenue of the United States for the Fifth District of New Jersey, to recover $72,010.22 with interest from June 15, 1917, paid under protest on assessment made for the taxable year of 1916. The case was tried to the court without a jury on an agreed statement of facts and judgment was rendered for the complainant for $70,980.03 with interest. Of this amount defendant concedes that complainant is entitled to recover $37,781.54.

The gross income of the railroad for 1916 was $35,854,392.03, from which it was conceded that there should be deducted as maintenance and operating expenses $30,112,403.68, leaving a net income of $5,741,988.35. From this amount complainant contends that there should be a further deduction of $1,659,924.33 spent for (1) additions and betterments to leased railroads and branches, (2) construction of, and extensions to, piers, and (3) dredging at piers. If these deductions are made, it would reduce the net income of the railroad from $5,741,988.35 to $4,082,064.02, and the taxes of $70,980.03 paid on the $1,659,924.33 should be allowed complainant. These allowances from the gross earnings must be made, if at all, under the following provision of the act of September 8, 1916:

"SEC. 12 (a). In the case of a corporation, joint stock company or association, or insurance company, organized in the United States, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources:

First. All the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, including rentals or other payments required to be made as a condition to the continued use or possession of property, to which the corporation has not taken or is not taking title, or in which it has no equity."

It is admitted that the complainant was in possession of these properties under leases, in some cases for long terms, and that
40 it has no equity in them, had not taken, and was not taking title to them and the expenditures were made within the year 1916. The real question is whether these expenditures, aggre-

gating $1,659,924.33, were, as defendant contends, "capital expenditures" or were, as complainant contends, ordinary and necessary expenses and rentals paid within the year, as a condition to the continued use and possession of the properties in question. If these expenditures belong to the former class, they are not deductible; if to the latter, they are.

The Central Railroad held the Lehigh and Susquehanna Railroad and its branches under a lease whose term began April 1, 1871, and extends not beyond 999 years from November 4, 1868, less one day. Under the terms of the lease, the complainant was "required to maintain and perpetuate said railroad and branches and to maintain and keep the same in good order and repair and fit for efficient use at its own cost and charges," and "to well and efficiently operate said railroad," it being "the true intent and meaning (of the lease) that the demised premises shall be so worked and maintained by the plaintiff as to secure the largest amount of revenue possible therefrom." For such work and materials as were required for repairing, renewing, improving, and increasing weight of rails, yard tracks, water supply facilities, bridges, equipment, and facilities, generally called "additions and betterments," the Central Railroad spent $103,496.68. It was admitted that this sum "was expended by plaintiff during the calendar year 1916 for additions and betterments necessary to maintain and perpetuate said Lehigh and Susquehanna Railroad and branches and to keep and maintain the same in good order and repair and fit for efficient use, under the terms of the said lease."

The Central Railroad was in possession of the Wilkes-Barre and Scranton Railroad by virtue of a lease which is dated May 1, 1888, and runs during the life of the charter less one day. This lease contains the same covenants as to operation and efficiency as does the lease in the case of the Lehigh and Susquehanna Railroad and in addition provides that if the covenants are broken and not performed upon notice and if the covenants in the lease of the Lehigh and Susquehanna Railroad are broken and that road reverts to the lessor, the Wilkes-Barre and Scranton Railroad shall also revert to the lessor. The complainant expended on building or renewing a station and retaining wall and bridge at Scranton $2,507.35. It was admitted that this money was expended in the year 1916 for "additions and betterments necessary to maintain and perpetuate said Wilkes-Barre and Scranton Railroad and to keep and maintain the same in good order and repair and fit for efficient use, under the terms of the aforesaid lease."

41

The complainant was in possession, as tenant in common with the Philadelphia and Reading Railroad Company, of the Allentown Terminal Railway under a lease for 999 years from July 10, 1889. The lease contained practically the same covenants as did the other two leases. The Central Railroad spent $232.31 as its share on improvements, interchange and rearrangement of tracks, etc. It was admitted that this amount was spent in 1916 "as its share of

the cost of additions and betterments to said Allentown Railroad which were necessary for the operation and maintenance of said railroad in good working order."

During the year 1916 complainant held Ogden Mine Railroad, within the State of New Jersey, for a term of 999 years. Under the terms of the lease, complainant is "required to at all times maintain and keep said railroad and all its appurtenances in good repair and condition and in all respects fit for use as a railroad." The lease further provides that if the complainant "shall fail to perform any of the covenants contained in the lease, within a reasonable time after request in writing so to do, then the lease may be terminated and declared forfeited and at an end."

It was admitted that $855.22 was expended by complainant in 1916 "for additions and betterments to said railroad necessary to maintain and keep the same in good repair and condition and in all respects fit for use as a railroad."

The complainant in 1916 was in possession of the Dover and Rockaway Railway under a lease dated April 26, 1881, for 999 years from April 1, 1881. The lease provided that "plaintiff is required at all times to maintain and keep the said railroad and all its appurtenances in good repair and condition and in all respects fit for use as a railway." $6,966.23 was spent in installing a telephone system on the road, renewing a bridge at Dover, increasing weight of rails and improving track material. It was admitted that these expenses were "for additions and betterments to said Dover and Rockaway Railway necessary to maintain and keep said railway and its appurtenances in good repair and in condition in all respects fit for use as a railway under the terms of the aforesaid lease."

New York City entered into a lease, for what is known as Pier 9 in that city at the foot of Carlisle Street, with the Lehigh Valley Railroad Company, dated January 13, 1914, and assigned it to the complainant. The city covenanted to condemn all the inter-
42 est of private owners in Pier (old) 9 and the complainant agreed to pay the entire cost of condemnation and to build, and in pursuance thereof did build, Pier (new) 9, a stone bulkhead wall, sheds on the pier, and a wharf extending fifty feet inshore from the bulkhead. It agreed to pay rent at the annual rate of 27½ cents per square foot for that portion not acquired, and $1.00 for that portion acquired, from private owners. The lease also provided if the entire cost of condemnation and improvements to the complainant was less than $2,750,000, it was to pay in addition 5½ per cent on the difference between the $2,750,000, and the actual cost, but if the cost was more than $2,750,000 the complainant was to be credited on its average annual rental with 5½ per cent on the difference for a term of thirty-nine years, the lease otherwise being for a term of ten years. The lease contained other provisions, under certain contingencies not here material, for the extension of the term. The city could terminate the lease at any time, if complainant failed

to perform any of its covenants. In 1916, complainant spent in the work provided for by the lease $1,525,308.72.

Complainant was in possession of Pier 80 at the foot of West 40th Street and Pier 46, North River, in 1916, in New York City, under leases for a ten-year term from the city. Under these leases complainant was required to do such dredging as the Commissioner of Docks of the city considered necessary. Complainant did dredging which the commissioner considered necessary and for which it spent $28.72 on the one and $38.10 on the other. The leases provided that the city could terminate them if complainant failed to observe their covenants.

Under two other leases from the city complainant was in possession of extensions to Piers 39 and 46, North River. These leases required the complainant to build extensions to these piers, and in so doing it spent $6,003.78 and $14,486.22 on each extension respectively. If complainant failed to perform the covenants of the leases, the city had the right to terminate them.

All these various properties, of which the Central Railroad was in possession under leases and on which it expended the $1,659,924.33, with their improvements, temporary and permanent, with their "additions and betterments," revert to the lessors upon the expiration or termination of the leases.

Were these expenditures ordinary and necessary expenses paid within the year 1916 as a condition to the continued use and possession of the properties? The force and effect of the pro-
43 visions of the lease and of the stipulated facts require an affirmative answer to this question. Article 140 of the Regulations 33 provides that:

"The cost of erecting permanent improvements on ground leased by a company, is held to be an additional rental and is therefore a proper deduction from gross income, provided such buildings and improvements, under the terms of the lease, revert to the owner of the ground at the expiration of the lease. In such case, however, the cost will be prorated according to the number of years constituting the term of the lease and the annual deduction will be an aliquot part of such cost."

This regulation is the interpretation of the statute by the department to which its endorsement is entrusted. It is conceded by both parties that the expenditures for these improvements are "additional rentals." Consequently the expenditures should be deducted from the gross income in order to ascertain the net income on which the tax must be paid. The real question is as to the time when the deductions should be made. The Government contends that they should be prorated in each case according to the number of years constituting the lease and that an aliquot part only should be deducted annually. The complainant, on the other hand, contends that they are rentals paid within the year 1916 as a condition to the continued use and possession of the prop-

erties and should be deducted for that year. A regulation of a Governmental department charged with the inforcement of an act has the force and effect of law, unless in itself it is unreasonable, inappropriate, and inconsistent with express statutory provision. United States v. Morehead, 243 U. S. 607, 613; Maryland Casualty Co. v. United States, 251 U. S. 342, 349. The question is reduced to this: Is the insistence that these expenditures be prorated in each case according to the number of years constituting the term of the lease and that the aliquot part be deducted annually, inconsistent with the express provisions of the statute? The statute expressly provides that all such rentals "paid within the year" may be deducted "from the gross amount of income received within the year" in order to ascertain the net income to be taxed. The evident intention of the statute is that the deduction of such rentals shall be made from the gross income "within the year" in which they were paid. McCoach v. Minehill Railway Co., 228 U. S. 295, 304. There is no hint in the statute that they shall be prorated over the term of years of the lease. We think that the provisions of the statute are plain, but if there be doubt, that doubt must be resolved against the Government. Gould v. Gould, 245 U. S. 151. That part of the regulation providing that only an aliquot part of such rentals shall be deducted each year during the life of the lease, we think, is inconsistent with the plain provisions of the statute and therefore the decree of the District Court is Affirmed.

[File endorsement omitted.]

44 In United States Circuit Court of Appeals

[Title omitted.]

Judgment. Filed May 3, 1923

In error to the District Court of the United States for the District of New Jersey.

This cause came on to be heard on the transcript of record from the District Court of the United States for the District of New Jersey, and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this court that the judgment of the said District Court in this cause be, and the same is hereby, affirmed.

J. WARREN DAVIS,
Circuit Judge.

PHILADELPHIA, May 3, 1923.

[File endorsement omitted.]

45 [Title omitted.]

Greeting:

Whereas, lately in the District Court of the United States for the District of New Jersey, before you or some of you, in a cause between Charles V. Duffy, collector of internal revenue (defendant

below), plaintiff in error, and the Central Railroad Company of New Jersey (plaintiff below), defendant in error, a judgment was entered in the said District Court on the twelfth day of April, 1922, which judgment is of record in the office of the clerk of the said District Court to which reference is hereby made and the
46 same is hereby expressly made a part hereof, as by the inspection of the transcript of the record of the said District Court, which was brought into the United States Circuit Court of Appeals for the Third Circuit by virtue of a writ of error, agreeably to the act of Congress, in such case made and provided, more fully and at large appears.

And whereas, in the term of October, in the year of our Lord one thousand nine hundred and twenty-two, the said cause came on to be heard before the said United States Circuit Court of Appeals on the said transcript of record and was argued by counsel:

On consideration whereof, it is now here ordered and adjudged by this court that the judgment of the said District Court in this cause be, and the same is hereby, affirmed.

PHILADELPHIA, May 3, 1923.

You, therefore, are hereby commanded that such execution and further proceeding be had in said cause as according to right and justice and the laws of the United States ought to be had, the said writ of error notwithstanding.

Witness, the Honorable William Howard Taft, Chief Justice of the Supreme Court of the United States, at Philadelphia, the fourth day of June, in the year of our Lord one thousand nine hundred and twenty-three (1923).

SAUNDERS LEWIS, JR.,
Clerk of the U. S. Circuit Court of Appeals, Third Circuit.

[File endorsement omitted.]

47 In United States Circuit Court of Appeals

Clerk's certificate

I, Saunders Lewis, jr., clerk of the United States Circuit Court of Appeals for the Third Circuit, do hereby certify the foregoing to be a true and faithful copy of the original record and proceedings in this court in the case of Charles V. Duffy, collector, plaintiff in error, vs. Central Railroad of New Jersey, defendant in error, on file, and now remaining among the records of the said court in my office.

In testimony whereof, I have hereunto subscribed my name and affixed the seal of the said court, at Philadelphia, this ninth day of July, in the year of our Lord one thousand nine hundred and twenty-three, and of the independence of the United States the one hundred and forty-eighth.

[SEAL.] SAUNDERS LEWIS, JR.,
Clerk of the U. S. Circuit Court of Appeals, Third Circuit.

48 *Writ of certiorari and return. Filed*

UNITED STATES OF AMERICA, *ss:*

The President of the United States of America to the honorable the Judges of the United States Circuit Court of Appeals for the Third Circuit, greeting:

Being informed that there is now pending before you a suit in which Charles V. Duffy, collector of internal revenue of the United States for the Fifth District of New Jersey, is plaintiff in error, and the Central Railroad Company of New Jersey is defendant in error, which suit was removed into the said Circuit Court of Appeals by virtue of a writ of error to the District Court of the United States for the District of New Jersey, and we, being willing for certain reasons that the said cause and the record and proceedings therein should be certified by the said Circuit Court of Appeals and
49 removed into the Supreme Court of the United States, do hereby command you that you send without delay to the said Supreme Court, as aforesaid, the record and proceedings in said cause, so that the said Supreme Court may act thereon as of right and according to law ought to be done.

Witness the Honorable William H. Taft, Chief Justice of the United States, the seventeenth day of October, in the year of our Lord one thousand nine hundred and twenty-three.

WM. R. STANSBURY,
Clerk of the Supreme Court of the United States.

[File endorsement omitted.]

50 [Title omitted.]

Stipulation as to return to writ of certiorari

It is hereby stipulated by counsel for the parties to the above entitled cause that the certified copy of the transcript of the record now on file in the Supreme Court of the United States shall constitute the return of the clerk of the United States Circuit Court of Appeals for the Third Circuit to the writ of certiorari granted therein.

JAMES M. BECK,
Scolicitor General.
CHARLES E. MILLER,
Counsel for Respondent.

OCTOBER 19, 1923.

[File indorsement omitted.]

51 UNITED STATES OF AMERICA,
Eastern District of Pennsylvania,
Third Judicial Circuit, Sct.

I, Saunders Lewis, jr., clerk of the United States Circuit Court of Appeals for the Third Circuit, do hereby certify the foregoing to be a true and faithful copy of the original stipulation as to return to writ of certiorari in the case of Charles V. Duffy, collector, plaintiff in error, vs. Central Railroad Company of New Jersey, defendant in error, No. 2925, on file, and now remaining among the records of the said court, in my office.

In testimony whereof, I have hereunto subscribed my name and affixed the seal of the said court, at Philadelphia, this 15th day of November, in the year of our Lord one thousand nine hundred and twenty-three and of the independence of the United States the one hundred and forty-eighth.

[SEAL.] SAUNDERS LEWIS, JR.,
Clerk of the U. S. Circuit Court of Appeals, Third Circuit.

52 [File indorsement omitted.]

WASHINGTON : GOVERNMENT PRINTING OFFICE : 1924

In the Supreme Court of the United States.

OCTOBER TERM, 1923.

CHARLES V. DUFFY, COLLECTOR OF INTERNAL REVENUE for the United States for the Fifth District of New Jersey, Petitioner,
v.
THE CENTRAL RAILROAD COMPANY OF NEW JERSEY, Respondent.
} No.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT, AND BRIEF IN SUPPORT.

The Solicitor General, on behalf of Charles V. Duffy, Collector of Internal Revenue for the Fifth District of New Jersey, prays that a writ of certiorari issued to review the judgment of the Circuit Court of Appeals for the Third Circuit, rendered in the above case on May 3, 1923, affirming the judgment of the District Court for the District of New Jersey.

STATEMENT OF THE CASE.

This is an action instituted by the Central Railroad Company of New Jersey, against Charles V. Duffy, Collector of Internal Revenue for the United States for the Fifth District of New Jersey, to recover back

income taxes in the sum of $72,010.22, with interest thereon from June 15, 1917, alleged to have been erroneously collected by petitioner from respondent for the year 1916. The case was tried before the District Court for the District of New Jersey, which gave judgment for the respondent in the sum of $70,980.03, and an appeal being taken to the Circuit Court of Appeals for the Third Circuit, the judgment of the District Court was affirmed. Petitioner now seeks to have this judgment of the Circuit Court of Appeals, affirming the judgment of the District Court, reviewed by writ of certiorari.

QUESTIONS INVOLVED.

I.

Whether expenditures made by a railroad company, on properties held by it under leases, for the construction of new buildings, new additions and betterments to old structures, new bridges, roadbeds, new tunnels, acquiring new lands, locating and paving new streets, are "ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties" within the meaning of Title I, Part II, Section 12 (a) of the Revenue Act of 1916 (39 Stat. 767).

II.

Whether expenditures made by a railroad company, on properties held by it under leases, for the construction of new buildings, new additions and betterments to old structures, new bridges, road-

beds, new tunnels, acquiring new lands, locating and paving new streets, are "rentals or other payments required to be made as a condition to the continued use or possession of the property to which the railroad company has not taken or is not taking title," within the meaning of Title I, Part II, Section 12 (a) of the Revenue Act of 1916 (39 Stat. 767).

III.

Is Article 140 of Treasury Department Regulations 33 (Revised) inconsistent with Section 12 (a) of the Revenue Act of 1916?

STATUTE INVOLVED.

Section 12 of the Revenue Act of 1916 reads in part as follows:

> SEC. 12. (a) In the case of a corporation, joint-stock company or association, or insurance company, organized in the United States, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources—
>
> First. All the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity * * *."

THE FACTS.

The Central Railroad of New Jersey during the year 1916 was the lessee of several branch railroads

under long-term leases. Under these leases the railroad company was required to maintain and keep the leased premises and all their appurtenances in good repair and condition, and in all respects fit for use as a railroad. The leases provided that the expenses for maintaining the leased premises should be borne by the respondent, and that at the termination of the leases all improvements erected thereon by the respondent should revert to and become the property of the lessors. The leases also contained the usual covenant that upon default in making payments of rental or in keeping the covenants, the lessor could terminate the lease by giving notice.

The respondent was also lessee from the city of New York of certain piers in the city of New York, under the terms of which the respondent agreed to construct new piers and extend old piers. The terms of these leases were for a less number of years than the railroad leases. They provided that the lessor, for the failure on the part of respondent to keep the covenants of the leases, could terminate the leases, and in such event all the improvements erected by the respondent would revert to and become the property of the lessor.

The Central Railroad Company of New Jersey during the year 1916 expended a total sum of $1,659,924.33 for (1) additions and betterments to its leased railroads and branches, (2) construction of and extension to leased piers, and (3) dredging the piers (the amount spent for dredging being only $66.62).

The expenditures made by the respondent on its leased railroads were for the construction of new buildings, new additions and betterments to old structures, improving roadbeds, buildings, new bridges, roadbeds, new tunnels, replacing old devices with new and better ones, acquiring new lands, and paving new streets. The unexpired terms of the leases were longer than the life of any of the improvements, and consequently the respondent will get the full beneficial use of them. None of these leases required the respondent to construct any of the above-named improvements.

The expenditures made by respondent under the leases held by the city of New York were for the construction of new piers and the extension of old piers. Therefore, all of the improvements for which respondent expended the sum of $1,659,924.33 were permanent, and constituted capital investments. These leases did not require the respondent to expend any sum whatsoever during the year 1916.

Respondent maintains and contends that it is entitled to deduct the full amount of $1,659,924.33 from its gross income for the year 1916 on the ground that this expenditure represented ordinary and necessary expenses paid within the year as a condition to the continued use of the leased premises.

The petitioner, however, contends that the said expenditure was a capital expenditure, and that the same could not be deducted all in one year, but should be prorated over the life of the improvements, or the life of the lease, whichever is shorter, as pro-

vided by Article 140 of Regulations 33 (revised), which is as follows:

> ART. 140. *Permanent improvements under lease.*—The cost of erecting permanent buildings, or of making permanent improvements on ground leased by a company, is held to be an additional rental and is therefore a proper deduction from gross income, provided such buildings and improvements, under the terms of the lease, revert to the owner of the ground at the expiration of the lease. In such case, however, the cost will be prorated according to the number of years constituting the term of the lease and the annual deduction will be an aliquot part of such cost. (As to income to lessor, see paragraph 50, page 11, these regulations.)

In rendering judgment the Circuit Court of Appeals held that the above regulation, in so far as it required a prorating of the expenditures, was inconsistent with the plain provisions of the statute.

REASONS FOR GRANTING THE PETITION.

1. The Circuit Court of Appeals erred in holding that the respondent was entitled to deduct the full sum of $1,659,924.33 from its gross income for the year 1916, expended for the construction of new buildings, new additions and betterments to old structures, new bridges, roadbeds, new tunnels, acquiring new lands and paving streets.

2. The Circuit Court of Appeals erred in holding that Article 140 of Regulations No. 33 (revised) in so far as it requires a prorating of the capital expenditures, was inconsistent with the provisions of Section 12(a) of the Revenue Act of 1916.

3. The construction of subdivision First of Section 12(a) of the Revenue Act of 1916 has never been before this court, nor before any lower court except in the instant case and the case of *Kemper Military School* v. *Crutchley*, 274 Fed. 125. In the latter case court reached an opposite conclusion to that reached by the Circuit Court of Appeals in the instant case, and, therefore, there is a conflict between Federal courts of different circuits.

4. The question involved in the present case is one of general interest and public importance to all taxpayers. (*Fields* v. *United States*, 205 U. S. 292). It not only involves hundreds of thousands of dollars in revenue to the Government but it also involves the equitable right of a taxpayer to a return of his money spent for capital improvements placed upon land held under lease. Under the decision of the Circuit Court of Appeals taxpayers having annual capital expenditures in excess of their annual incomes are denied their equitable right to a full return of their capital, e. g., a taxpayer, as lessee of land which produces no income, expends during a current year $2,000,000 for the construction of a new building. He realizes no income from the building until the following year, and, therefore, if compelled to take the deduction in the year the expenditures were made, he would never get a return of his capital expenditures.

JAMES M. BECK,
Solicitor General.
MABEL WALKER WILLEBRANDT,
Assistant Attorney General.

BRIEF IN SUPPORT OF PETITION.

The fundamental question in this case is whether the expenditures made by the respondent for the purposes herein set forth were capital expenditures. If they were capital expenditures, then they can not under any interpretation of the law be deducted in full in determining the net taxable income for the year 1916. They must be spread over the life of the improvements or over the life of the lease, whichever is shorter. In order to sustain the judgment of the Circuit Court of Appeals it will be necessary to hold that the expenditures were "ordinary and necessary expenses paid within the year in the maintenance and operation" of its business and properties "as a condition to the continued use and possession" of its leased properties.

POINT I.

The construction of new buildings, new additions and betterments to old structures, new bridges, roadbeds, new tunnels, acquiring new lands, locating and paving new streets, were not "ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties," and therefore are not proper deductions within the meaning of Title I, Part II, Section 12 (a) of the Revenue Act of 1916 (39 Stat. 767).

The expenditures made by the respondent on its leased properties were not "ordinary and necessary expenses paid within the year in the maintenance and

operation of its business and properties," but were capital expenditures. They were not such improvements as ordinarily recur in the operation of respondent's business. What constitutes capital expenditures and what constitutes ordinary and necessary expenses has been determined by this court in the case of *Illinois Central Railroad Co.* v. *Interstate Commerce Commission*, 206 U. S. 441, in which, at page 462, the following language was used:

> The findings show that the old rates were profitable and that the dividends were declared even when permanent improvements and equipment were charged to operating expenses. But may they be so charged? Appellants contend that the answer should be so obviously in the affirmative that it should be made an axiom in transportation. On principle it would seem as if the answer should be otherwise. It would seem as if *expenditures for additions, to construction and equipment, as expenditures for original construction and equipment, should be reimbursed by all of the traffic they accommodate during the* period of their duration, and that *improvements that will last many years should not be charged wholly against the revenue of a single year.*

And at page 463:

> We think, it is clear, that instrumentalities which are to be used for years should *not be paid for by the revenues of a day or year;* and this is the principle of returns upon capital which exists in durable shape. [Italics ours.]

The second subdivision of Section 38 of the Corporation Excise Act of 1909 (36 Stat. 112) provides among other things:

> Second. Such net income shall be ascertained by deducting from the gross amount of the income of such corporation, joint-stock company or association, or insurance company, received within the year from all sources, (first) all the ordinary and necessary expenses actually paid within the year out of income in the maintenance and operation of its business and properties, including all charges such as rentals or franchise payments, required to be made as a condition to the continued use or possession of property; * * *

It is thus seen that this section is almost identical with Section 12(a) of the Revenue Act of 1916.

Under this section the Grand Rapids & I. Ry. Company claimed the right to deduct from its gross income money expended for additions and betterments to its properties, but this was denied by the Commissioner of Internal Revenue, whereupon it instituted suit against Emanuel J. Doyle, Collector of Internal Revenue for the District of Michigan (*Grand Rapids & I. Ry. Co.* v. *Doyle*, 245 Fed. 792) to recover the amount of the taxes paid. In the course of its opinion the court said:

> * * * Are these expenditures included in the "necessary expenses of the maintenance and operation of the plaintiff's railway property and business?" In my judgment, they are not. In each instance it is an addition to

the property, and an addition to the value of the property of the railway company. It is an improvement of its property; it is an extension of its property; it is an addition not only to its inventory value but to its real and actual value.

It is a well-known fact that corporations in general, both railway and manufacturing companies, often use a part of their net earnings and income in the extension and improvement of their plans and property and business. Nearly every corporation of an industrial character does that, and in many cases industrial corporations do not declare dividends for a number of years after their organization, for the very reason that they are extending and improving an addition to their property. But amounts so expended in additions are no less income than they would be if paid to the stockholders as dividends, and no less income or additions to the value than if the amount had been carried into a surplus account and placed in bank.

The case of *Kemper Military School* v. *Crutchley*- 274 Fed. 125, arose in the Western District of Mis, souri, and as heretofore stated, involved the interpretation of Section 12 (a) of the Revenue Act of 1916, and in that case the taxpayer was denied the right to deduct expenditures for capital improvements from gross income of a single year.

POINT II.

The expenditures made by respondent were not payments of rentals or other payments required under the terms of the lease as a "condition to the continued use or possession of its properties" for the year 1916 within the meaning of the Revenue Act of 1916, Section 12(a).

None of the leases required the respondent to erect new buildings, bridges, tunnels, or any new improvements, except the leases requiring the construction of the new piers and the extension of the old piers, and none of the leases required the respondent to expend the said sum of $1,659,924.33, or any part thereof, during the year 1916. Therefore, these expenditures were not recurring expenditures, and were not ordinary and necessary within the meaning of Section 12(a) of the Revenue Act of 1916 and were not a condition to the continued use of respondent's properties.

POINT III.

Article 140 of Regulations 33 (Revised) is consistent with Section 12(a) of the Revenue Act of 1916.

At the time the above regulation was promulgated to carry into effect the provisions of Section 12(a) of the Revenue Act of 1916, it was recognized by those entrusted with the enforcement of the law that taxpayers who erected new buildings on properties held under lease could not always obtain a return in full of their capital expenditures if they were compelled to take the deduction from the gross income for the year in which the capital expendi-

tures were made. During the year in which a taxpayer expends large amounts for capital improvements, his income is insufficient to permit a full deduction of the expenditures. With this in mind, the officials of the Treasury Department provided in the regulations referred to that the cost of permanent improvements placed upon leased property should be prorated over the life of the lease or over the life of the improvements, whichever is shorter, allowing every taxpayer who erects permanent improvements on his leased property a return in full of his capital expenditures. As heretofore stated, the decision of the Circuit Court of Appeals denies the taxpayer this right, as it compels the taxpayer to take the deduction for capital expenditures during the year in which expenditures were made.

The executive construction of Section 12(a), as shown by the regulations, was known to Congress when it enacted Section 234(a) of the Revenue Act of 1918, which is almost identical with Section 12(a) of the Revenue Act of 1916, and in effect constitutes a reenactment of that section. This reenactment, therefore, is an approval or ratification on the part of Congress of such construction. (*United States* v. *Falk*, 204 U. S. 143; *United States* v. *Hermanos y Campania*, 209 U. S. 337; *Komada* v. *United States*, 215 U. S. 392; and *National Lead Co.* v. *United States*, 252 U. S. 140.)

CONCLUSION.

In conclusion, it is respectfully submitted that the writ of certiorari should be issued as prayed.

JAMES M. BECK,
Solicitor General.

MABEL WALKER WILLEBRANDT,
Assistant Attorney General.

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In the Supreme Court of the United States.

OCTOBER TERM, 1924

CHARLES V. DUFFY, COLLECTOR OF INTERNAL REVENUE FOR THE UNITED STATES FOR THE FIFTH DISTRICT OF NEW JERSEY, petitioner
v.
THE CENTRAL RAILROAD COMPANY OF NEW JERSEY

No. 129

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE PETITIONER

STATEMENT

This writ of certiorari brings up for review a decision of the Circuit Court of Appeals for the Third Circuit, affirming a judgment of the United States District Court for the District of New Jersey, made after findings of fact, awarding to The Central Railroad Company of New Jersey $70,980.03, a portion of the income taxes assessed against it for the calendar year 1916, under the Revenue Act of September 8, 1916, ch. 463, Title I, Part II, section 12 (a), 39 Stat.

767, and paid under protest by the taxpayer. The award also included interest, bringing the total judgment up to $91,812.66.

The cause was submitted to the District Court without a jury upon an agreed statement of facts, to be found in the record at pages 4 to 15.

From the findings of fact it appears that the gross income of the taxpayer for the calendar year 1916 was $35,854,392.03 (First Finding, p. 15).

The net income as determined by the Commissioner of Internal Revenue amounted to $5,741,998.35, upon which a total tax was assessed and paid of $152,621.31 (Second Finding, p. 15; Ninth Finding, p. 16). The net income as determined by the District Court is $4,082,064.02 (Eighth Finding, p. 16), upon which the Government is entitled to a tax of $81,641.29 (Rec. 13). The difference in these two items of net income, $1,659,924.33, involving $70,983.03 of the total tax paid, represents certain expenditures made by the taxpayer during 1916, which the court found to be deductible under the provisions of the Revenue Act of 1916 from the net income as determined by the Commissioner of Internal Revenue.

The Circuit Court of Appeals states in its opinion (Rec. 20) that of the judgment for $70,980.03 the petitioner concedes that the taxpayer is entitled to recover $37,781.54. In explanation thereof petitioner calls attention to paragraph 8 of the agreed statement of facts, at page 13 of the record, wherein it is agreed that the total tax due on the

net income of $5,741,988.35 is $114,839.77. In paying a total tax, therefore, of $152,621.31 the taxpayer overpaid, through error in computation, $37,781.54.

During the year 1916 the taxpayer was the lessee of several branch railroads under long-term leases. Thereunder the lessee was required to maintain and keep the leased premises, together with all appurtenances thereto, in good repair and condition, and in all respects fit for use as a railroad. The taxpayer was further obligated to pay all of the expenses for maintaining the leased premises. At the termination of the leases, all improvements erected thereon by the taxpayer revert to and become the property of the lessors. Each lease also contains the usual covenant that upon default in rental or in fulfilling the covenants the lessor could terminate the lease by giving notice.

The expenditures made by the taxpayer during the year 1916 upon the properties covered by these leases are set forth alphabetically from A to E in paragraph 6 in the agreed statement of facts at pages 5 to 9 of the record.

In addition to these leases there were also leases from the city of New York of certain piers in that city, under the terms of which the lessee agreed to construct new piers and extend old piers. The terms of these leases were for a less number of years than the railroad leases. They provided that the lessor, for the failure on the part of the lessee to keep the covenants of

the leases, could determine them, in which event all the improvements erected upon the demised property would revert to and become the property of the lessor. The expenditures made under the leases last mentioned are set forth with particularity in paragraph 6 of the agreed statement of facts, alphabetically from F to J, at pages 9 to 12 of the record.

The total sum thus disbursed by the taxpayer was for (1) additions and betterments to its leased railroads and branches, (2) construction and extension of leased piers, and (3) dredging the piers (the amount spent for dredging being only $66.62).

The expenditures made by the taxpayer on its leased railroads were for the construction of new buildings, new additions and betterments to old structures, improving roadbeds, buildings, and for new bridges, new roadbeds, new tunnels, replacing old devices with new and better ones, acquiring new lands, and paving new streets. The disbursements made for these purposes are itemized in Exhibit A to the agreed statement of facts, at pages 13, 14, and 15 of the record. The unexpired terms of these leases were longer than the life of any of the improvements and, therefore, the taxpayer will get the full beneficial use of them. None of the leases, however, required the taxpayer to construct any of the above-named improvements. The expenditures made by the taxpayer under the leases granted by the city of New

York were for the construction of new piers and extension of old piers. These leases did not require the lessee to expend any sum whatsoever during the year 1916 for additions.

The Court of Appeals in affirming the judgment of the District Court held that all of the expenditures under consideration were additional rentals; that section 12 (a), subdivision first, allowed these to be deducted within the year made, and that the provisions of article 140 of regulations 33 (revised) are inconsistent with the plain terms of the act (Rec. 23, 24).

The specific questions involved are:

First. Are these disbursements, aggregating $1,659,924.33, *capital* expenditures to be spread over the term of the lease and an aliquot part deducted in the tax return for each year or can the cost be deducted in a lump sum in the year when paid?

Second. Are the expenditures *ordinary* and *necessary* expenses which may be deducted in the year made?

Third. Are the expenditures rentals paid within the year as a condition to the continued use and possession of the leased properties and deductible in the year made, or must they be prorated in accordance with the regulations of the Treasury Department?

The taxpayer contends that the expenditures in question are rentals within the meaning of section 12 (a) of the Revenue Act of 1916, paid as a condition to the continued use and possession of the

property, and should be deducted from the gross income for the year 1916.

The petitioner contends: First, that these disbursements constitute *capital* expenditures, within the meaning of section 12 (a), Title I, Part II, of the Revenue Act of 1916 and article 132 of Regulations 33 (revised), and that, therefore, the only allowable deduction under section 12 (a), subdivision second, is an annual deduction for "depreciation." Second, that the expenditures made by the taxpayer were not *ordinary* and *necessary* expenses within the meaning of section 12 (a) of the Revenue Act of 1916. Third, that, if it be determined that the expenditures are additional rentals within the meaning of section 12 (a), first subdivision, they can not be deducted all in one year, but must be prorated over the life of the improvements, or the life of the lease, whichever is shorter, in accordance with article 140 of Regulations 33 (revised).

STATUTES AND REGULATION INVOLVED

Title I, Part II, section 12 (a), of the Revenue Act of 1916 (39 Stat. 767), provides *inter alia:*

> SEC. 12 (a). In case of a corporation, joint-stock company, or association, or insurance company organized in the United States, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources—

First. All the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity.

* * * * *

Second. All losses actually sustained and charged off within the year and not compensated by insurance or otherwise, including a reasonable allowance for the exhaustion, wear, and tear of property arising out of its use or employment in the trade; or business * * *: *Provided,* That no deduction shall be allowed for any amount paid out for new buildings, permanent improvements, or betterments made to increase the value of any property or estate, and no deduction shall be made for any amount of expense of restoring property or making good the exhaustion thereof for which an allowance is or has been made. (39 Stat. 768.)

Article 140, Regulations 33 (revised), reads:

ART. 140. *Permanent improvements under lease.*—The cost of erecting permanent buildings, or of making permanent improvements on ground leased by a company, is held to be an additional rental and is therefore a proper deduction from gross income, provided such buildings and improvements, under the terms of the lease,

revert to the owner of the ground at the expiration of the lease. In such case, however, the cost will be prorated according to the number of years constituting the term of the lease and the annual deduction will be an aliquot part of such cost.

Article 132, Regulations 33 (revised), reads:

> *Additions and betterments.*—Amounts expended in additions and betterments, or for furniture and fixtures which constitute an increase in capital investment and add to the value of the assets, are not a proper deduction, but such expenditures when capitalized may be extinguished through annual depreciation deductions, which latter deductions will be computed upon the basis of the cost and probable life of the property.

I

All of the disbursements made by the taxpayer upon the premises occupied under the long-term leases are capital expenditures, and the only deduction allowable therefor under the Revenue Act of 1916 is an annual deduction for depreciation

The facts in this case demand that substance and not form must be considered in determining whether the items of disbursement involved are for taxing purposes, capital expenditures, or ordinary and necessary expenses or rentals.

In 1916 and for a long time prior thereto the taxpayer was in possession, as lessee, of certain properties under leases from the Lehigh & Susquehanna Railroad, the Allentown Terminal Railroad, the Ogden Mine Railroad, and the Dover &

Rockway Railroad. Each of these four leases was for a term of 999 years, commencing at a time long prior to 1916. It was also in possession of properties under a lease from the Wilkes-Barre & Scranton Railroad under a lease which ran for the length of the charter of the lessor, less one year, the charter being perpetual, but subject to alteration and repeal by the Legislature of Pennsylvania.

It is admitted under the agreed statements of fact that all of the expenditures made upon the property covered by these leases were for additions and betterments.

Technically speaking, of course, it is true that so far as the leases just mentioned are concerned the taxpayer is a lessee. But this does not mean that the payments made were rental, within the purview of section 12 (a). Indeed the admitted facts surrounding these particular leases conclusively show that the expenditures made upon these demised premises are *capital investments.* In the first place, it can not be denied that all of these improvements will eventually become a total loss by depreciation within the life of the leases which run for 999 years. This undoubtedly makes the taxpayer the *potential* owner of the properties. The reason for this conclusion is obvious. The lessors will not receive any beneficial use whatever from the improvements to the properties covered by these long-term leases, because their beneficial life will be extinguished long before the termina-

tion of the leases. In this situation, therefore, it is indeed a solecism to say that these additions and betterments constitute rental within the meaning of section 12 (a), when in fact the payments made constitute a *capital* investment to the same extent as if the taxpayer was the owner of the fee of these properties. These disbursements, therefore, partaking of the character of capital investments, can not be deducted under the *express* language of section 12 (paragraph second), which reads:

> *Provided,* That no deduction shall be allowed for any amount paid out for new buildings, permanent improvements, or betterments made to increase the value of any property or estate * * *.

The expenditures made under these long-term leases can not be classed as " ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties," for they were not such improvements as ordinarily recur in the operation of the taxpayer's business.

What constitutes " capital expenditures " and what constitutes " ordinary and necessary expenses " has been determined by this court in the case of *Illinois Central Railroad Co.* v. *Interstate Commerce Commission,* 206 U. S. 441, in which the following language was used at page 462:

> The findings show that the old rates were profitable and that the dividends were declared even when permanent improve-

> ments and equipment were charged to operating expenses. But may they be so charged? Appellants contend that the answer should be so obviously in the affirmative that it should be made an axiom in transportation. On principle it would seem as if the answer should be otherwise. It would seem as if *expenditures for additions, to construction and equipment, as expenditures for original construction and equipment, should be reimbursed by all of the traffic they accommodate during the period of their duration, and that improvements that will last many years should not be charged wholly against the revenue of a single year.*

Again at page 463 it is said:

> We think, it is clear, that instrumentalities which are to be used for years should *not* be *paid for by the revenues of a day or year;* and this is the principle of returns upon capital which exists in durable shape. (Italics supplied.)

The language used in section 38 of the Corporation Excise Act of 1909 (36 Stat. 112) is almost identical with section 12 (a) of the Revenue Act of 1916. In *Grand Rapids & I. Ry. Co.* v. *Doyle,* 245 Fed. Rep. 792, the question arose as to whether expenditures made for additions and betterments were "necessary expenses of the maintenance and operation of the railway property and business," and therefore deductible from the gross income under section 38 of the act of

1909. In disposing of this proposition the court at page 796 says:

> * * * Are these expenditures included in the "necessary expenses of the maintenance and operation of the plaintiff's railway property and business"? In my judgment, they are not. In each instance it is an addition to the property, and an addition to the value of the property of the railway company. It is an improvement of its property; it is an extension of its property; it is an addition not only to its inventory value but to its real and actual value.
>
> It is a well-known fact that corporations in general, both railway and manufacturing companies, often use a part of their net earnings and income in the extension and improvement of their plans and property and business. Nearly every corporation of an industrial character does that, and in many cases industrial corporations do not declare dividends for a number of years after their organization, for the very reason that they are extending and improving an addition to their property. But amounts so expended in additions are no less income than they would be if paid to the stockholders as dividends, and no less income or additions to the value than if the amount had been carried into a surplus account and placed in bank (p. 797).

As to this phase of the case, therefore, it is certain that the disbursements made upon the

property covered by these long-term leases are *capital* expenditures and, under the express terms of the Revenue Act of 1916, are not deductible in the year made, the only deduction allowed being for annual depreciation. *Union Pac. R. R. Co.* v. *United States,* 99 U. S. 402, 420; *Illinois Cent. R. R. Co.* v. *Interstate Commerce Commission,* 206 U. S. 441, 462; *United States* v. *Central Pacific R. Co.,* 138 U. S. 84; *Kemper Military School* v. *Crutchley,* 274 Fed. 125; *Union Hollywood Water Co.* v. *Carter,* 238 Fed. 329; *Walker* v. *Gulf and I. Railway Co.,* 269 Fed. 885; *Grant* v. *Hartford, etc., R. R. Co.,* 93 U. S. 225; *Haw. C. & S. Co.* v. *Tax Assessor,* 14 Haw. Rep. 601; *People* v. *Wilson,* 121 App. Div. 376, 106 N. Y. S. 1, 193 N. Y. 673; *Highland Railway Co.* v. *Balderston* (*1889*), 26 Scot. L. R. 657, 2 Gr. Br. Tax Cas. 485; *Clayton* v. *Newcastle Corp.,* 2 Gr. Br. Tax Cas. 416.

II

All of the disbursements made for additions and betterments upon the properties leased from the city of New York are capital expenditures, hence are not deductible in the year made under section 12 (a) of the Revenue Act of 1916 from the gross income for that year, but the cost should be spread over the term of the lease and an aliquot part deducted annually

The total expenditure made for additions and betterments upon the properties covered by the foregoing long-term leases amounts $114,058.79. The remaining $1,545,865.54 of the total disbursements involved in the case relate to expenditures made upon properties covered by leases

from the city of New York, and these will now be considered.

A disbursement of $1,525,308.72 was made by the taxpayer in 1916 for the construction of a new pier, known as Pier No. 9, located on property covered by a lease from the city to the taxpayer by assignment. This lease was dated January 13, 1914, and a supplement thereto was dated March 14, 1914. The term thereof was for 10 years from 1914, subject to two renewals of 10 years, and a further renewal of 9 years. There was also a further proviso for a still further extension, depending upon the total cost of the new pier. This lease provided among other things that certain land on the water front would be obtained by the city by condemnation, and when acquired the lessee was to proceed with improvements of the water front including the building of the new pier, a stone bulkhead wall, and sheds on the pier and upon the marginal street, wharf, or place extending inshore a distance of 50 feet from the bulkhead, including the filling in of the rear of the bulkhead and the paving of the street, wharf or place extending from the bulkhead line inshore to the westerly line of West Street, in accordance with plans, specifications, and estimates of costs approved by the city. The rental agreed upon was at the rate of 27½ cents per square foot per annum for the portion of the demised area not acquired from private owners

and at the rate of $1 a year for the property acquired from private owners. The lease further provided that if the entire cost of condemnation and the improvements to the taxpayer was less than $2,750,000, it was to pay in addition 5½ per cent on the difference between the $2,750,000 and the actual cost, but if the cost was more than $2,750,000 the taxpayer was to be credited on its average annual rental with 5½ per cent on the difference for a term of 39 years, the lease otherwise being for a term of 10 years, with the right of renewal, as already mentioned. The city could terminate the lease at any time after 10 years from the commencement thereof, but in case of such termination, *the city to pay such reasonable sum to the taxpayer as may be fixed by arbitrators* provided for in the lease. It also contained the usual cancellation clause, in the event of default by the lessee. (Rec. 9, 10, 11.)

With regard to this item of expenditure it is claimed by the taxpayer that it constitutes " rental " or " ordinary and necessary expense " within the meaning of section 12 (a) of the Revenue Act of 1916.

The improvement is of a permanent nature. It was not an outlay for the maintenance of property. It is a capital asset from which the taxpayer will derive the benefit of increased pier facilities, resulting in increased revenues. That was the purpose for which it was built. The

beneficial result obtained therefrom will not be confined to one year, but many years. There is nothing in the language of the lease which would indicate in the slightest degree that the parties thereto contemplated a payment of rental of $1,500,000 in *one year*. On the contrary, the terms of the instrument show clearly that the rental is to be spread over the entire period of the lease. In fact, the lease did not provide for this expenditure in 1916, or in any one year. The fact that the pier was constructed in 1916 is no criterion upon which to base the conclusion that it was rental due for that year. But even if the leases involved had provided that these expenditures should be made in 1916, they would be payments for the continued use of the properties, not only for 1916, but for each succeeding year during the entire life of the leases, and would, therefore, have to be pro-rated.

In allowing deductions for rental, Congress undoubtedly intended that the rentals would only be deductible if the taxpayer was bound to make the payment in that year in order to obtain the continued use or possession of the demised premises. This is evidenced by the language used in section 12 (a), which reads:

> * * * including rentals or other payments *required* to be made as a condition to the continued use or possession of property. (Italics supplied.)

This language negatives any intent to allow deductions, other than for depreciation, for payments made in improving property or for capital expenditures, when such disbursements are merely made to accommodate the business of the taxpayer, as in case at bar.

Time is one of the fundamental facts in the taxation of incomes. The tax is laid upon income within a period of time. In this case from January 1 to December 31 of any given year. This same fundamental fact applies with equal force to deductions which Congress allows. They cover items of expenditure which are necessary in the maintenance of the taxpayer's business or property during the taxable period. It makes little difference whether it be for repairs or rent. Both income and deductions are computed upon a year's business. The income is not to be based upon one year's earnings and deductions therefrom upon a 10 or 15 year period *at the option of the taxpayer*. If it were so intended, undoubtedly Congress would have used unmistakable language in section 12 (a) to convey such an intent.

Read in the light of this construction of section 12 (a), which its language undeniably supports, article 140 of Regulations 33 (revised) is a reasonable regulation, affording as it does an equitable relief to a taxpayer who, for the purpose of

increasing his business capacity, makes extensive improvements upon leased property, by allowing a deduction for capital expenditures upon a prorated basis, which he otherwise would not be entitled to, unless the payment was *required* to be made in order to continue in possession of the premises. Moreover, this executive construction of section 12 (a), as shown by the regulations, was known to Congress when it enacted section 234 (a) of the Revenue Act of 1918, which is almost identical with section 12 (a) of the Revenue Act of 1916, and in effect constitutes a reenactment of that section. This reenactment, therefore, is an approval or ratification on the part of Congress of such construction. *United States* v. *Falk,* 204 U. S. 143; *United States* v. *Hermanos y Compania,* 209 U. S. 337; *Komada* v. *United States,* 215 U. S. 392; *National Lead Co.* v. *United States,* 252 U. S. 140.

This expenditure, however, partakes not of the character of rental but more in the nature of a *capital* investment. This is supported by the very terms of the lease, which provide that the city may terminate the lease at any time, in which event the taxpayer will be paid for this improvement. This is entirely inconsistent with the idea that the expenditures were made as rent, for if so then there would not be a provision for the return of such expenditures. In other words, the lease provides expressly for a return of "capital."

The Court of Appeals in its opinion has stated, "it is conceded by both parties that the expenditures for these improvements are 'additional rentals.'" This apparently is a mistake, for there is nothing in the agreed statements of fact which can be construed as conceding this to be the fact. But should it be determined that this expenditure of $1,545,865.54 is rental, it must be deducted upon a prorated basis as provided by article 140 of Regulations 33 (revised). It can not be allowed as a deductible item for the year in which the total expenditure was made.

It is said that this item constitutes "ordinary and necessary expense" or "rental" within the meaning of section 12 (a). It is hard to conceive how the phrase " to keep and maintain the premises and structures thereon, or to be erected thereon, in efficient repair and condition" can be construed to mean an expenditure of over a million and a half dollars in the erection and construction of the very premises that the plaintiff agrees to keep and maintain in good condition. The statement of the proposition is itself a refutation of such a contention.

This brings us to the two remaining leases and the items of expenditure made for additions and betterments upon the demised premises.

During 1916 the taxpayer was in possession of an extension to Pier No. 46, from the city of New York. The term of the lease expired October 25,

1924. The rental is 27½ cents per square foot per annum for the area of land under water covered by the extension. This lease provided that the taxpayer construct an extension to Pier No. 46 and a shed thereon under the direction of the city engineer. The property reverts to the city upon the termination of the lease. The costs of these improvements amounted to $14,486.22.

These improvements were not required under the terms of the lease to be made in 1916. Therefore, if the disbursements made therefor constitute rental, they are not deductible, except upon a prorated basis under article 140 of Regulations 33 (revised). The same is true with regard to the remaining lease, dated December 30, 1913, which runs for a term of 10 years, plus one extension of 10 years, and covers extension to Pier No. 39, North River, N. Y. This lease is very similar in terms to the other. The expenditure was for $6,003.78, the cost of an extension to Pier No. 39. The lease did not provide that this expenditure was to be made in 1916. In fact, the lease had been in force for nearly three years before this extension was constructed. This item can not be deducted except upon a prorated basis in accordance with article 140 of Regulations 33 (revised), if it be determined that it is rental.

The items expended for dredging, while small in amount, are controlled by the above principles. They have been held to constitute capital expend-

itures. *Ounsworth* v. *Vickers, Ltd.* (1915), 3 K. B. 267; *Dumbarton Harbour Board* v. *Cox* (1919), Scot. Cas. 162, 56 Scot. L. Reporter 122.

To avoid repetition, the argument on the question of what constitutes an "ordinary and necessary expense," made under heading I of this brief relative to the long-term leases, is adopted as applicable to the other leases considered above.

CONCLUSION

The judgment of the court below should be reversed.

JAMES M. BECK,
Solicitor General.

ALFRED A. WHEAT,
Special Assistant to the Attorney General.

NOVEMBER, 1924.

○

IN THE

Supreme Court of the United States

CHARLES V. DUFFY, Collector of Internal Revenue for the United States for the Fifth District of New Jersey, Petitioner, *v.* THE CENTRAL RAILROAD COMPANY OF NEW JERSEY, Respondent.	No.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

The petition filed in this cause prays for the issuance of a writ of certiorari to review a judgment of the Circuit Court of Appeals for the Third Circuit, affirming a judgment for $70,980.03 with interest, rendered in favor of the respondent Railroad Company by the United States District Court for the District of New Jersey in an action instituted to recover back a portion of the income tax assessed against it for the year 1916. The action was tried by the court without a jury on an agreed statement of facts. It was conceded that the Railroad was entitled to recover $37,781.54. Whether the balance of the judgment is right depends upon whether the Railroad Company was entitled to deduct from its gross income for the year 1916 the sum of $1,659,924.33, which it expended dur-

ing that year for (1) additions and betterments to leased railroads and branches; (2) construction of and extensions to piers; and (3) dredging at piers.

There is no dispute as to the facts which are set out in detail in the agreed statement of facts and in the opinion of the Court below. For present purposes it is sufficient to point out that these expenditures were made during the year 1916 to improve properties held under lease; that the Railroad Company had no equity in these properties, and that it had not taken or was not taking title to them; that the leases under which these properties were held required the Railroad Company to make the improvements and authorized the lessors to terminate them if the improvements were not made; and that under their terms title to the improvements when made vested in the lessors.

Both the District Court and the Circuit Court of Appeals held that the amounts so expended were rentals or other payments required to be made by the Railroad Company as a condition to the continued use or possession of property, and that it was entitled to deduct them from its gross income for the year in which they were made under the Revenue Act of 1916, which provides:

> "Sec. 12 (a) In the case of a corporation, joint-stock company or association, or insurance company, organized in the United States, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources—
>
> "First. All the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, including rentals or other payments required to be made as a condition to the continued use or possession of property to

> which the corporation has not taken or is not taking title, or in which it has no equity * * *."

The Government contends that the amounts so expended were capital expenditures, and cites *Grand Rapids & I. Ry. Co.* v. *Doyle*, 245 Fed. 792, and *Kemper Military School* v. *Crutchley*, 274 Fed. 125, which it asserts are in conflict with the decision below. Those cases, however, involved improvements made by a corporation to property which it owned and in them it was held properly that amounts expended for such improvements were not deductible from income. Here, however, the Government does not deny the right to deduct. It argues merely that the deduction should be spread over a period of years fixed either by the life of the improvement or the term of the lease, whichever is shorter.

In effect, the position taken by the Government is an effort to sustain Article 140 of the regulations promulgated under the Revenue Act of 1916 by the Commissioner of Internal Revenue (Regulations 33 Revised), which provides as follows:

> "*Article 140. Permanent Improvements Under Lease.* The cost of erecting permanent buildings or of making permanent improvements on ground leased by a company is held to be an additional rental and is therefore a proper deduction from gross income, provided such buildings and improvements, under the terms of the lease, revert to the owner of the ground at the expiration of the lease. In such case, however, the cost will be prorated according to the number of years constituting the term of the lease, and the annual deduction will be an aliquot part of such cost."

Since the right to deduct the expenditures involved here is conceded both in the argument advanced in this case and by the regulations adopted by the Commissioner of Internal Reve-

nue, the only question in the case is whether all of such expenditures made within the year may be deducted in that year, or whether they should be prorated over a term of years, as is contended for by the Government.

The solution of this question depends upon whether the regulation of the Commissioner of Internal Revenue is consistent with the express terms of the statute. If it is not, it must fall. *United States* v. *Morehead*, 243 U. S. 607, 613; *Maryland Casualty Co.* v. *United States*, 251 U. S. 342, 349; *International Railway Co.* v. *Davidson*, 257 U. S. 506, 514. On this point, the Court below said:

> "The statute expressly provided that all such rentals 'paid within the year' may be deducted 'from the gross amount of income received within the year' in order to ascertain the net income to be taxed. The evident intention of the statute is that the deduction of such rentals shall be made from the gross income *'within the year'* in which they are paid. *McCoach* v. *Minehill Railway Co.*, 228 U. S. 295, 304. There is no hint in the statute that they shall be prorated over the term of years of the lease. We think that the provisions of the statute are plain, but if there be doubt, that doubt must be resolved against the Government. *Gould* v. *Gould*, 245 U. S. 151. That part of the regulation providing that only an aliquot part of such rentals shall be deducted each year during the life of the lease, we think, is inconsistent with the plain provisions of the statute."

It is respectfully submitted that the decision of the Court below was right and that the petition for a writ of certiorari should be denied.

CHARLES E. MILLER,
Counsel for Respondent,
THE CENTRAL RAILROAD COMPANY OF NEW JERSEY.

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IN THE

Supreme Court of the United States

CHARLES V. DUFFY, Collector of Internal Revenue for the United States for the Fifth District of New Jersey, Petitioner, *v.* THE CENTRAL RAILROAD COMPANY OF NEW JERSEY, Respondent.	No. 129, October Term, 1924.

BRIEF FOR RESPONDENT THE CENTRAL RAILROAD COMPANY OF NEW JERSEY

Statement of the Case.

The writ of certiorari allowed in this case brings before the Court a decision of the Circuit Court of Appeals for the Third Circuit affirming a judgment of the District Court for the District of New Jersey entered in favor of the Railroad Company in an action instituted to recover back a portion of the income tax assessed against it for the year 1916.

It appears from the agreed statement of facts upon which the case was tried below that the gross income of the Railroad Company for the year 1916 was $35,854,392.03 (R., p. 5).

The Government concedes that the Railroad Company was entitled to deduct therefrom $30,112,403.68, and that as the result of a miscalculation the tax assessed against it is excessive by $37,781.54 (R., pp. 5, 13).

The question presented for decision in this case is whether the Railroad Company is entitled to additional deductions aggregating $1,659,-924.33. If it is, the tax assessed against it is excessive by $70,980.03 (R., p. 13), the amount for which it obtained judgment below (R., p. 17).

The deductions thus in controversy represent amounts expended during the year 1916 for improvements to properties held by the Railroad Company under lease. The Revenue Act of 1916 provides as follows:

> "Sec. 12 (a). In the case of a corporation, joint stock company or association, or insurance company, organized in the United States, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources—
>
> "First. All the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, including rentals or other payments required to be made as a condition to the continued use or possession of property, to which the corporation has not taken or is not taking title, or in which it has no equity."

The Railroad Company contends that since the leases under which these properties were held required it to make the improvements involved, it is entitled to deduct the amounts so expended upon the ground that they were rentals or other payments required to be made as a condition to the continued use or possession of property, and that if they were rentals or payments required to be made as a condition to the continued use or possession of property, it is entitled to deduct the full amount of all such expenditures made within the year.

Statement of the Facts.

Of the $1,659,924.33 expended by the Railroad Company for improvements to leased properties during 1916, $1,545,798.72 was spent for the construction of piers and extensions to piers, $66.82 was spent for dredging at piers, and $114,058.70 for additions and betterments to leased railroads and branches.

The Expenditures for the Construction of Piers and Extensions to Piers

The expenditures for the construction of piers and extensions to piers were as follows:

New Pier 9 and bulkhead.....	$1,525,308.72
Extension to Pier 46.....	14,486.22
Extension to Pier 39.....	6,003.78

New Pier 9. New Pier 9 was held by the Railroad Company under a lease from the City of New York by which the City leased to the Railroad Company a plot of land under water near the foot of Carlisle Street, in the City of New York. The City agreed to condemn all the right, title and interest of private owners in the existing Old Pier 9 and in the bulkhead, and the Railroad Company agreed to defray the entire cost of such condemnation, including awards, fees of Commissioners and experts, and all other necessary disbursements.

The lease further provided that on the vesting of title to such property in the City, the Railroad Company should at once proceed with the improvement of the water front by building a new Pier 9, a stone bulkhead wall, sheds on the pier

and on the marginal street extending inshore a distance of 50 feet from the bulkhead, and by filling in in the rear of the bulkhead, and paving the marginal street in accordance with plans, specifications and estimates of cost approved by representatives of the City.

The Railroad Company agreed to pay 27½ cents per square foot per annum for the portion of the demised premises not acquired from private owners, and the sum of $1.00 per year for the property so acquired from private owners. It was provided, however, that if the cost of the improvements, including the entire cost of the condemnation proceeding, the cost of building the new pier, bulkhead wall, sheds, etc., and of filling in in the rear of the bulkhead and paving the marginal street, should be less than $2,750,000, the Railroad Company should pay annually, in addition to the above amount, 5½ per cent. on the difference between $2,750,000 and such entire cost; that if the cost of the improvements should be greater than the sum of $2,750,000, the Railroad Company should be credited upon the average annual rental for a term of 39 years with an amount equal to 5½ per cent. upon the difference between said cost and the sum of $2,750,000; and in the event that 5½ per cent. on said difference should exceed the average rental, it was provided that the term of the lease should be extended for a period which should bear the same proportion to 39 years as the amount of excess cost over the sum of $2,750,000, plus the sum upon which 5½ per cent. is equal to the amount of rental for the land over that acquired from private owners should bear to $2,750,000.

The lease specifically provided that the piers, bulkhead, sheds or other improvements made or erected in accordance with its terms should re-

vert to and become the property of the City at the expiration or sooner termination thereof.

The term of the lease is for ten years, plus two renewals of ten years each, and a further renewal of nine years, or for such longer period as the Railroad Company may be entitled to in accordance with its terms, in the event that the cost of the improvement exceeds $2,750,000, but on each renewal, the payments provided for increase ten per cent.

Additionally, the lease provided that in the event that the Railroad Comapny should fail to pay the rent for a space of ten days, or to perform, keep, do or observe any or either of the covenants, agreements, things, terms or conditions thereof, the City might terminate the same.

The amount expended during 1916 was for the construction of a new pier and bulkhead in accordance with the terms of this lease (R., p. 9).

Pier 46. Pier 46 was held under a lease from the City of New York, which by its terms expired on October 25, 1924. Under it the Railroad Company was required to construct an extension to the pier and a shed thereon under the direction and supervision of the City authorities, and to pay 27½ cents per square foot per annum for the area of land under water covered by such extension.

The lease specifically provided that the extension and shed should revert to the City at the expiration or sooner termination of the lease, and gave the City the right to terminate it if the Railroad Company should fail to perform the covenants thereof.

The amount expended in 1916 was for the construction of an extension to this pier as required by the lease (R., p. 12).

Pier 39. The lease covering Pier 39 is similar to that covering Pier 46. Under it the Railroad Company was required to build an extension to the pier which reverts to the City on the expiration of the lease, and the City was specifically given the right to terminate the lease if the Railroad Company should fail to perform the covenants thereof.

During 1916 the Railroad Company expended $6,003.78 for the construction of an extension to Pier 39 as required by the lease (R., p. 12).

The Expenditures for Dredging at Piers

The expenditures for dredging at piers were as follows:

Dredging north side Pier 80.....	$28.72
Dredging north side Pier 46.....	38.10

The dredging involved was done at piers in the City of New York which were held by the Railroad Company under leases which specifically required it to do such dredging as the City authorities directed and which specifically gave the City the right to terminate them in the event that the Railroad Company should fail to do such dredging (R., p. 11).

Expenditures for Additions and Betterments to Leased Railroads and Branches

The expenditures for additions and betterments to leased railroads and branches were as follows:

Additions and betterments to Lehigh and Susquehanna Railroad and branches.....	$103,496.68
Additions and betterments to Wilkes-Barre and Scranton Railroad	2,507.35
Additions and betterments to Allentown Terminal Railroad.	232.31

Additions and betterments to Ogden Mine Railroad.....	855.22
Additions and betterments to Dover & Rockaway Railroad..	6,967.23

Lehigh & Susquehanna Railroad and Branches. This road was held under a lease requiring the lessee to maintain and perpetuate the leased line and to keep and maintain it in good order and repair and fit for efficient use. The lease provided that all additions and betterments made by the lessee should, when and as the same are constructed, become part of the demised premises, and the lessor is given the right to terminate the lease upon the breach of its terms.

Additions and betterments made in 1916 included improving the roadbed, right of way and facilities, renewing bridges, increasing the weight of rail, installing siding facilities, installing road crossing bells, installing telephone lines, installing yard tracks, increasing water supply facilities, and replacing and changing signals.

The agreed statement of facts shows that these additions and betterments were required by the terms of the lease under which the line was held (R., p. 5).

Wilkes-Barre & Scranton Railroad. The lease under which the Wilkes-Barre & Scranton Railroad was held contained provisions generally similar to those contained in the lease of the Lehigh & Susquehanna Railroad, and provided that if for any reason the lease of the Lehigh & Susquehanna Railroad should be terminated the lease of the Wilkes-Barre & Scranton should terminate also, and the property revert to the lessor. Under it the lessee is required to make the necessary additions and betterments which revert to the lessor when made, and the lessor is given

the right to terminate the lease upon breach of its terms.

Additions and betterments made in 1916 included renewing a bridge, constructing a passenger station, and increasing the weight of rail.

The agreed statement of facts shows that the additions and betterments made in 1916 were required by the terms of the lease (R., p. 6).

Allentown Terminal Railroad. This line was held by the Railroad Company as tenant in common with another railroad under a lease which required the lessees to maintain and keep the road in good working order, and to bear the cost of all permanent improvements necessary or convenient for the operation, use or enjoyment thereof, and which gave the lessor the right to terminate it upon breach of its terms. It was also provided that the lease should terminate if the above mentioned lease of the Lehigh & Susquehanna Railroad should be terminated.

Additions and betterments made in 1916 included improving track material, rearranging tracks, the construction of a siding and delivery tracks, purchasing additional land, and resetting paving and curbing.

The agreed statement of facts shows that these additions and betterments were required by the terms of the lease (R., p. 7).

Ogden Mine Railroad. The Ogden Mine Railroad was held under a lease which required the lessee to at all times maintain and keep the road and its appurtenances in good repair and condition and in all respects fit for use as a railroad, and which gave the lessor the right to terminate it if the lessee failed to perform any of its covenants.

Additions and betterments made in 1916 in-

cluded the installation of a telephone dispatching system and the acquisition of land.

The agreed statement of facts shows that these additions and betterments were required by the terms of the lease (R., p. 8).

Dover & Rockaway Railroad. This road was held under a lease which required the lessee to maintain and keep it and all its appurtenances in good repair and condition at all times, and in all respects fit for use as a railroad, and which gave the lessor the right to terminate it upon default by the lessee in performing its covenants.

Additions and betterments made in 1916 included renewing bridges, increasing rail weight, improving track material and installing sidings.

The agreed statement of facts shows that the additions and betterments made in 1916 were required by the terms of the lease (R., p. 9).

Argument.

In interpreting statutes levying taxes, the established rule is not to extend their provisions, by implication, beyond the clear import of the language used or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt, they are construed most strongly against the Government and in favor of the citizen. *U. S.* v. *Wigglesworth,* 2 Story 369. *American Net & Twine Co.* v. *Worthington,* 141 U. S. 468, 474; *Benziger* v. *U. S.,* 192 U. S. 38, 55. *Gould* v. *Gould,* 245 U. S. 151, 153.

The Act of 1916 provides that the net income of a corporation shall be ascertained by deducting from the gross income received within the year,

> "First. All the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and

> properties, including rentals or other payments required to be made as a condition to the continued use or possession of property, to which the corporation has not taken or is not taking title, or in which it has no equity."

While the word "including" may "merely specify particularly that which belongs to the genus" it may also be used as a word of enlargement and have the sense of "also" and of "in addition." *Montello Salt Co.* v. *Utah*, 221 U. S., 452, 462, 464, and it is frequently so used by Congress. *U. S.* v. *Pierce*, 147 Fed. 199.

Adopting this latter sense of the word, the Act of 1916 may be read as permitting a corporation to deduct, first, the ordinary and necessary expenses paid in the maintenance and operation of its business and property, and second, rentals or other payments required to be made as a condition to the continued use or possession of property. And, since a tax act must be construed against the Government and in favor of the citizen this act must be so construed.

This being so, it follows that the Railroad Company is entitled to deduct the amounts involved here if they were (1) rentals, or (2) payments required to be made as a condition to the continued use or possession of property, and (3) the Railroad Company had not taken or was not taking title to the properties involved and had no equity in them.

THE EXPENDITURES INVOLVED HERE WERE RENTALS.

In *Miller* v. *Gearin*, 258 Fed. 225 (Certiorari denied, 258 U. S. 667) decided by the Circuit Court of Appeals for the Ninth Circuit, it appeared that an owner of land had made a lease in 1907 which required the tenant to construct

an expensive brick building. On the tenant's default, the owner retook possession of the demised premises in 1916. It was contended by the Government that the value of the building was taxable income which accrued to the landowner in 1916. This contention was rejected by the court, which said:

> "The lessor acquired nothing in 1916 save the possession of that which for many years had been her own. The possession so acquired was not income. It was not a gain, but a loss. Assuming that the building was income derived from the use of the property, we think it clear that the time when it was 'derived' was the time when the completed building was added to the real estate and enhanced its value. *At that time it represented a repayment to the lessor of a portion of the rental,* distributed over a period of 23 years." (Italics ours.)

By the regulations promulgated by the Commissioner of Internal Revenue, under the Revenue Act of 1916 it is provided:

> "Art. 140. Permanent improvements under lease.—The cost of erecting permanent buildings, or of making permanent improvements on ground leased by a company is held to be an additional rental and is therefore a proper deduction from gross income, . . ."

The expenditures involved here, therefore, were rentals.

THE EXPENDITURES INVOLVED IN THIS CASE WERE PAYMENTS REQUIRED TO BE MADE AS A CONDITION TO THE CONTINUED USE OR POSSESSION OF PROPERTY.

Attributing to the word condition its usual and natural significance, it is evident that the statute

permits the deduction of any payments, the failure to make which would entitle the landowner to terminate the use or possession of the property.

In *42 Broadway Company* v. *Anderson* the question was whether a realty corporation having a nominal capital but a large bonded indebtedness secured by mortgages upon its real estate was entitled to deduct the full amount of the interest paid on its bonded indebtedness. The case arose under section 38 of the Corporation Tax Act of 1909, the second paragraph of which, like the Act of 1916, authorized the deduction of charges required to be made as a condition to the continued use or possession of property, but the third paragraph of which authorized the deduction of interest only on an amount of bonded or other indebtedness not exceeding the paid up capital stock.

The District Court for the Southern District of New York (209 Fed. 991), and the Circuit Court of Appeals for the Second Circuit (213 Fed. 777) held that the full amount of interest could be deducted from the gross income notwithstanding the limitation contained in the third paragraph of section 38, upon the ground that the interest payments involved were charges required to be made as a condition to the continued use or possession of the property.

The District Court said, 209 Fed. 992:

> "The interest paid on the mortgages was one of 'the ordinary and necessary expenses actually paid within the year out of income in the maintenance and operation of its business and properties,' and it was a charge *'such as rental or franchise payments, required to be made as a condition to the continued use or possession of property.' If*

> *the interest on the mortgages had not been paid, the mortgages would have been foreclosed, the property sold, and the continued use and possession of the property and the entire business of the corporation terminated.*" (Italics ours.)

The Circuit Court of Appeals said, 213 Fed. 778:

> "The government admits that if the interest had not been paid the mortgages would by their terms have fallen due, and if foreclosed the company would have lost its property. It seems to us that these payments of interest on bonds of a corporation engaged in the realty business secured on its realty were ordinary and necessary expenses in the 'maintenance and operation' of such business, and were also charges required to be paid as a 'condition of the continued use or possession' of its property within subdivision 1 of paragarph 2 of section 38."

The case was reversed by this court upon the ground that the lower courts had erred in seeking a theoretically accurate definition of "net income," instead of adopting the meaning clearly defined in the act itself, 239 U. S. 69. The court said, however (p. 72):

> "It may well be that mortgage interest may, under special circumstances, be treated as among the 'ordinary and necessary expenses,' or as included among the charges 'required to be made as a condition to the continued use or possession of property.' (See 28 Opin. A. G. 198.)"

The agreed statement of facts shows that the leases under which the properties involved here were held required the Railroad Company to make the improvements involved, and contained

provisions entitling the lessors to terminate such leases if the improvements were not made. The expenditures for making such improvements, therefore, were payments required to be made as a condition to the continued use or possession of property.

THE RAILROAD COMPANY HAD NOT TAKEN OR WAS NOT TAKING TITLE TO THE PROPERTIES INVOLVED HERE AND HAD NO EQUITY IN THEM.

The words "to which the corporation has not taken or is not taking title, or in which it has no equity," did not appear either in the Corporation Tax Act of 1909 or in the Income Tax Act of 1913. They were included in the Revenue Act of 1916 as the result of a recommendation of the Secretary of the Treasury made after the decisions of the lower courts in *42 Broadway Co.* v. *Anderson, supra, Benders Federal Revenue Law,* 1916, Annotated, p. 64. The purpose of the amendment proposed by the Secretary of the Treasury was to distinguish "between the interest due on liens and mortgages from any payment made in the nature of rentals or charges constituting in the ordinary sense an expense of the business." See report, Secretary of the Treasury, fiscal year ending June 30, 1915, p. 99.

The genesis of the phrase, therefore, suggests that in using the word "equity," Congress had in mind the equity of redemption, which is defined as the remaining interest belonging to one who has pledged or mortgaged his property.

It is to be noted, moreover, that the word "equity" is used in the Act in connection with the word "title," which is defined as "the means whereby the owner of lands hath the just possession of his property." *2 Bl. Comm. 195.*

In view of the genesis of the phrase and of the context in which the word is used, it is submitted that "equity" means equitable ownership, and even if it be possible to give it a broader interpretation, it is the duty of the court to construe it most strongly against the Government. *Gould* v. *Gould, supra.*

The properties involved in this case were held under leases. Ownership of them both at law and in equity remained in the lessors, and the Railroad Company had neither title to nor equity in them. Nor does the fact that some of the leases granted long terms alter the situation, for no matter how long the terms such leases did not operate to transfer ownership either in law or in equity from the lessors to the lessee.

It is urged, however, that while technically the Railroad Company is not the owner of the properties held under long term leases, the court should consider substance and not form, and that viewed in this light the Railroad Company is the *potential owner* of such properties. But this the court may not do, for to do so would enlarge the operation of the statute by construing it in favor of the Government.

SINCE THE EXPENDITURES INVOLVED WERE RENTALS OR OTHER PAYMENTS REQUIRED TO BE MADE AS A CONDITION TO THE CONTINUED USE OR POSSESSION OF PROPERTY TO WHICH THE RAILROAD COMPANY HAD NOT TAKEN OR WAS NOT TAKING TITLE AND IN WHICH IT HAD NO EQUITY, IT IS ENTITLED TO DEDUCT THE WHOLE OF SUCH EXPENDITURES FROM ITS GROSS INCOME FOR THE YEAR 1916.

Since the expenditures involved here are of the kind which may be deducted, it is clear that the statute, by express words, permits the deduc-

tion of all of such expenditures made within the year. There is no hint in the statute that the payments which may be deducted are to be prorated. The words of the statute are "all . . . paid within the year."

In *Mutual Benefit Co.* v. *Herold,* 198 Fed. 199, the District Court of the District of New Jersey dealing with the language employed in the Corporation Tax Act of 1909, which as the Government points out is similar to the language of the Act of 1916, said (p. 215):

> "Since, then, the language of the Act is explicit in permitting only such deductions from the gross income as were actually paid during the current year, it would be strange, indeed, if on the opposite side of the account the Company were charged with what it had not received during the current year."

And this language was cited with approval by the District Court for the Western District of Louisiana in *United States* v. *Christine Oil & Gas Co.,* 269 Fed. 458.

In *Southern Pacific R. Co.* v. *Muenter,* 260 Fed. 837, decided by the Circuit Court of Appeals for the Ninth Circuit, a corporation had sold bonds at a discount which were to run for thirty-one years. It had set up on its books as a deduction from its income for each year of the thirty-one year period one-thirty-first part of the total discount. The case arose under the Tax Act of 1909 which permitted the deduction from gross income of all losses actually sustained during the year. The Court said:

> "We think the present case is determined adversely to the plaintiff-in-error by the plain language of the statute. The money set apart upon the books each year until the maturity of the bonds to meet the loss which

> came from selling the bonds below par was the application of a prudent and proper system of business and was a wise provision for the future; but it was not the payment of interest, nor did it represent a loss actually sustained within the year. The money was not in fact paid out. Notwithstanding the books of the plaintiff-in-error, the money is still in its possession and subject to its control. A system of bookkeeping will not justify the Government in claiming taxes, nor will it justify the taxpayer in claiming exemptions from taxpaying. The facts must control."

The Government seeks to support the contention that the expenditures involved here should be prorated by the regulation of the Commissioner of Internal Revenue above referred to, which requires such deductions to be prorated according to the number of years constituting the term of the lease, and which permits the annual deduction of only an aliquot part.

It is settled that the power to make administrative rulings does not include the power to legislate, *U. S.* v. *George*, 228 U. S. 14, and that such a regulation to be valid must be consistent with the statute under which it is made. *International Railroad Company* v. *Davidson*, 257 U. S. 506, 514. See also *Maryland Casualty* v. *U. S.*, 251 U. S. 342, 349 and cases cited.

Since the Revenue Act of 1916 specifically permits all of the expenditures mentioned therein which are made within the year to be deducted, the regulation of the Commissioner is in conflict therewith, and must fall. *Cryan* v. *Wordell*, 263 Fed. 248.

In dealing with this article of the regulations, the court below said:

> "A regulation of a governmental depart-

ment charged with the enforcement of an act has the force and effect of law, unless in itself it is unreasonable, inappropriate and inconsistent with express statutory provision. United States *v.* Morehead, 243 U. S. 607, 613; Maryland Casualty Co. *v.* United States, 251 U. S. 342, 349. The question is reduced to this: Is the insistence that these expenditures be prorated in each case according to the number of years constituting the term of the lease and that the aliquot part be deducted annually, inconsistent with the express provisions of the statute? The Statute expressly provides that all such rentals 'paid within the year' may be deducted 'from the gross amount of income received within the year' in order to ascertain the net income to be taxed. The evident intention of the statute is that the deduction of such rentals shall be made from the gross income '*within the year*' in which they are paid. McCoach *v.* Minehill Railway Co., 288 U. S. 295, 304. There is no hint in the statute that they shall be prorated over the term of years of the lease. We think that the provisions of the statute are plain, but if there be doubt, that doubt must be resolved against the Government. Gould *v.* Gould, 245 U. S. 151. That part of the regulation providing that only an aliquot part of such rentals shall be deducted each year during the life of the lease, we think, is inconsistent with the plain provisions of the statute." 289 Fed. 354, 358.

THE CONTENTIONS OF THE GOVERNMENT.

It is contended by the Government that the expenditures involved here should not be deducted from the Railroad Company's income for the year 1916 because they are capital expenditures. In support of this contention the Government cites certain language used by this court in the case of *Illinois Central Railroad Co.* v. *Interstate Commerce Commission,* 206 U. S. 441,

at page 462. In that case the court was called upon to review an order of the Interstate Commerce Commission holding certain advances in rates for the transportation of lumber unreasonable. It was urged, among other things, that the Commission had erred as a matter of law in failing to take into account in determining the reasonableness of the increased rates certain improvements claimed to have been made necessary by an abnormal increase of traffic. Upon this point the court held that even if the Commission were wrong as to such expenses, error in its ultimate conclusion was not demonstrated, nor was the correctness of its conclusion made so doubtful as to justify a reversal, for whether such improvements should be taken into account was a mixed question of law and fact upon which the finding of the Commission was conclusive. The language cited by the Government is, therefore, *dicta*, and the facts in the case clearly distinguish it.

In *Grand Rapids & I. Ry. Co.* v. *Doyle*, and in *Kemper* v. *Crutchley*, which the Government also cites, the improvements involved were made to the property owned by the corporations claiming the deductions. This fact clearly distinguishes those cases from the present case, for amounts expended from income for improvements, the title to which remains in the taxpayer, do not diminish the income. Money is simply invested. Such improvements are in fact, additions to the corporation's capital. But here title to the improvements involved vested in the lessors as soon as the Railroad Company made them, under the terms of the leases as well as by operation of law, for it is a familiar rule that when structures are erected by persons not owners of the land, they become part of the realty and,

as such, the property of the land owner. *Kutter* v. *Smith*, 2 Wall 491; *International Navigation Co.* v. *Barker*, 153 N. Y. 98; *Miller* v. *Gearin*, *supra*. While the improvements involved here became part of the capital investment of the lessors, so far as the Railroad Company is concerned, the amounts expended in making them represent merely expenditures in the nature of rentals, and while such improvements may increase the Railroad Company's income in the future, any such future income will be subject to taxation and the Government will lose nothing. See *Union Pacific Co.* v. *U. S.*, 99 U. S. 402.

But the determination of whether the Railroad Company is entitled to deduct the amounts involved in this case does not depend upon whether or not such amounts were capital expenditures. The only question here is whether the Railroad Company can bring them within the words of the statute when it is construed most strongly against the Government. If it can, it is entitled to deduct them.

Again it is urged that the deduction of the expenditures made in connection with the properties held under long term leases is contrary to the proviso of the second paragraph of Section 12 of the Act of 1916, reading as follows:

> "*Provided*, That no deduction shall be allowed for any amount paid out for new buildings, permanent improvements, or betterments made to increase the value of any property or estate."

As the basis for this contention it is argued that while technically the Railroad Company is a lessee, it is in fact the potential owner of the properties held by it under long term leases, and it is urged that the court should consider sub-

stance and not form in determining the matter. This amounts to no more than an effort to induce the court to construe the act liberally in favor of the Government, but this the court may not do. The court cannot extend the provisions of the act, by implication, beyond the clear import of the language used, or enlarge its operations so as to embrace matters not specifically pointed out, and in case of doubt it must be construed most strongly against the Government and in favor of the citizen. *Gould* v. *Gould, supra,* and cases cited.

Since the Railroad Company is in fact a lessee, the court may not limit the right to make deductions given it by the act by treating it as a potential owner.

This contention, moreover, is in direct conflict with the interpretation placed on the act by the Commissioner of Internal Revenue. Article 140 of Regulations 33 (Revised) *supra,* expressly recognizes the right of a lessee to deduct expenditures made in permanently improving leased property, and this right is recognized irrespective of the term of the lease.

Additionally, even if the leasehold interests which the Railroad Company has in the properties involved here can be regarded as property or an estate in the sense in which these words are used in the act, the improvements made by it were not "made to increase the value" of such property or estate, but were made under the compulsion of the leases.

These considerations also answer the contention which is stated but not argued, that the expenditures involved here may not be deducted in full under Article 132 of the Regulations of the Commissioner of Internal Revenue, for the amounts expended here in fact added nothing to

the Railroad Company's capital investment, or to the value of its assets, for it lost title to the improvements involved as soon as it made them.

It is also urged that the expenditures involved may not be deducted because the leases did not require them to be made in 1916, but the statute imposes no such requirement. It provides that they may be deducted if they were paid within the year and were required to be made as rentals or as a condition to the continued use or possession of the property. The agreed statement of facts shows that the expenditures here were paid in 1916 and that the leases required them to be made.

With respect to the amounts expended in connection with New Pier 9, it is urged that they should not be deducted, because the lease contains a provision authorizing the lessor to terminate it before the end of its term and in such case requires the lessor to pay the lessee such reasonable sum as may be fixed by arbitration. But this does not justify denying the Railroad Company the right to deduct the amount it expended in connection with this pier from its gross income for the year in which such expenditures were made. The City may not terminate the lease, and if the Railroad Company must wait until the end of the term before its right to deduct these amounts is determined, it will lose the right to deduct anything, for by the terms of the statute it may deduct such amounts only wtihin the year in which they are expended. *Southern Pacific R. Co.* v. *Munter, supra;* while if the lease is terminated before the end of the term and anything is repaid to the Railroad Company as the result thereof, such amounts will be taxable as income for the year in which they are repaid.

Finally, it is argued that the enactment by Congress of a provision of the Revenue Act of 1918, almost identical with the provision of the Act of 1916 involved here, is an approval or ratification of the regulation of the Commissioner under the Act of 1916 upon the principle that Congress is presumed to have legislated with knowledge of the construction placed on a statute by the Executive Department of the Government charged with its administration. While this contention would be of great weight if the Act of 1918 were involved in this case, it cannot serve to justify a regulation under the Act of 1916, which, as has already been shown, is in plain conflict with the statute.

Conclusion.

IT IS RESPECTFULLY SUBMITTED THAT THE JUDGMENT BELOW SHOULD BE AFFIRMED.

CHARLES E. MILLER,
Attorney and Counsel
for Respondent.

property etc., since "rental" is there used in the usual sense implying a fixed sum, or property amounting thereto, payable at stated times for the use of property, and "other payments" means payments *ejusdem generis* with rentals, such as taxes, insurance, etc. P. 63.

289 Fed. 354, reversed.

CERTIORARI to a judgment of the Circuit Court of Appeals affirming a recovery in the District Court of money paid under protest as income tax.

Mr. Alfred A. Wheat, Special Assistant to the Attorney General, for petitioner. *The Solicitor General* was on the brief.

All of the disbursements made by the taxpayer upon the premises occupied under the long-term leases are capital expenditures, and the only deduction allowable under the Revenue Act of 1916 is an annual deduction for depreciation. Technically speaking, of course, it is true that so far as the leases just mentioned are concerned the taxpayer is a lessee. But this does not mean that the payments made were rental, within the purview of § 12 (a). Indeed the admitted facts surrounding these particular leases conclusively show that the expenditures made upon these demised premises are capital investments, and, under the express terms of the Revenue Act of 1916, are not deductible in the year made, the only deduction allowed being for annual depreciation. *Union Pac. R. R. Co.* v. *United States*, 99 U. S. 402; *Ill. Cent. R. R. Co.* v. *Interstate Comm. Comm.* 206 U. S. 441; *United States* v. *Central Pac. R. R. Co.* 138 U. S. 84; *Kemper Military School* v. *Crutchley*, 274 Fed. 125; *Grand Rapids, etc., Ry. Co.* v. *Doyle*, 245 Fed. 792; *Union Hollywood Water Co.* v. *Carter*, 238 Fed. 329; *Walker* v. *Gulf & I. Ry. Co.* 269 Fed. 885; *Grant* v. *Hartford, etc., R. R. Co.* 93 U. S. 225; *Haw. C. & S. Co.* v. *Tax Assessor*, 14 Haw. Rep. 601; *People* v. *Wilson*, 121 N. Y. App. Div. 376; *Highland Ry. Co.* v. *Balderston*,

2 Gr. Br. Tax Cas. 485; *Clayton* v. *Newcastle Corp.* 2 Gr. Br. Tax Cas. 416.

All of the disbursements made for additions and betterments upon the properties leased from the city of New York are capital expenditures, hence are not deductible in the year made under § 12 (a) of the Revenue Act of 1916 from the gross income for that year, but the cost should be spread over the term of the lease and an aliquot part deducted annually. A disbursement was made by the taxpayer in 1916 for the construction of a new pier, located on property covered by a lease from the city to the taxpayer by assignment. The improvement is of a permanent nature. It was not an outlay for the maintenance of property. It is a capital asset from which the taxpayer will derive the benefit of increased pier facilities, resulting in increased revenues. Read in the light of this construction of § 12 (a), which its language undeniably supports, article 140 of Regulations 33 (revised) is a reasonable regulation, affording as it does an equitable relief to a taxpayer who, for the purpose of increasing his business capacity, makes extensive improvements upon leased property, by allowing a deduction for capital expenditures upon a prorated basis, which he otherwise would not be entitled to, unless the payment was required to be made in order to continue in possession of the premises. Moreover, this executive construction of § 12 (a), as shown by the regulations, was known to Congress when it enacted § 234 (a) of the Revenue Act of 1918, which is almost identical with § 12 (a) of the Revenue Act of 1916, and in effect constitutes a reënactment of that section. This reënactment, therefore, is an approval or ratification on the part of Congress of such construction. *United States* v. *Falk,* 204 U. S. 143; *United States* v. *Hermanos y Compania,* 209 U. S. 337; *Komada* v. *United States,* 215 U. S. 392; *National Lead Co.* v. *United States,* 252 U. S. 140.

The items expended for dredging, while small in amount, are controlled by the above principles. They have been held to constitute capital expenditures. *Ounsworth* v. *Vickers*, Ltd. 3 K. B. 267; *Dumbarton Harbour Board* v. *Cox*, Scot. Cas. 162, 56 Scot. L. Reporter 122.

Mr. Charles E. Miller, for respondent.

While the word "including" may "merely specify particularly that which belongs to the genus" it may also be used as a word of enlargement and have the sense of "also" and of "in addition," *Montello Salt Co.* v. *Utah*, 221 U. S. 452, 462, 464, and it is frequently so used by Congress. *United States* v. *Pierce*, 147 Fed. 199.

Adopting this latter sense of the word, the Act of 1916 may be read as permitting a corporation to deduct, first, the ordinary and necessary expenses paid in maintenance and operation of its business and property, and second, rentals or other payments required to be made as a condition to the continued use or possession of property. And, since a tax act must be construed against the Government and in favor of the citizen, this act must be so construed.

This being so, it follows that the Railroad Company is entitled to deduct the amounts involved here if they were (1) rentals, or (2) payments required to be made as a condition to the continued use or possession of the property, and (3) the Railroad Company had not taken or was not taking title to the properties involved and had no equity in them.

The expenditures involved here were rentals, *Miller* v. *Gearin*, 258 Fed. 225; Regulations, Commissioner Int. Rev., 1916, Art. 140—payments required to be made as a condition to the continued use or possession of property. Attributing to the word condition its usual and natural

significance, it is evident that the statute permits the deduction of any payments the failure to make, which would entitle the landowner to terminate the use or possession of the property. *42 Broadway Co.* v. *Anderson,* 209 Fed. 991 (reversed by this court upon another ground, 239 U. S. 69).

The Railroad Company had not taken, or was not taking, title to the properties and had no equity in them. The words "to which the corporation has not taken or is not taking title, or in which it has no equity," did not appear either in the Corporation Tax Act of 1909 or in the Income Tax Act of 1913. They were included in the Revenue Act of 1916 as the result of a recommendation of the Secretary of the Treasury, made after the decisions of the lower courts in *42 Broadway Co.* v. *Anderson, supra;* Benders Federal Revenue Law, 1916, p. 64. The purpose of the amendment proposed by the Secretary of the Treasury was to distinguish "between the interest due on liens and mortgages and any payment made in the nature of rentals or charges consituting in the ordinary sense an expense of the business." See report, Secretary of the Treasury, fiscal year ending June 30, 1915, p. 99.

The genesis of the phrase, therefore, suggests that in using the word "equity," Congress had in mind the equity of redemption, which is defined as the remaining interest belonging to one who has pledged or mortgaged his property. "Equity" means equitable ownership, and even if it be possible to give it a broader interpretation, it is the duty of the court to construe it most strongly against the Government. *Gould* v. *Gould,* 245 U. S. 151.

The Railroad Company is entitled to deduct the whole of such expenditures from its gross income for the year 1916. Since the expenditures involved here are of the kind which may be deducted, it is clear that the statute,

by express words, permits the deduction of all of such expenditures made within the year. There is no hint in the statute that the payments which may be deducted are to be prorated. The words of the statute are "all . . . paid within the year." *Mutual Benefit Co.* v. *Herold,* 198 Fed. 199; *United States* v. *Christine Oil & Gas Co.* 269 Fed. 458; *Southern Pac. R. Co.* v. *Muenter,* 260 Fed. 837. The Government seeks to support the contention that the expenditures involved here should be prorated by the regulation of the Commissioner of Internal Revenue. It is settled that the power to make administrative rulings does not include the power to legislate, *United States* v. *George,* 228 U. S. 14, and that such a regulation to be valid must be consistent with the statute under which it is made. *International Railroad Company* v. *Davidson,* 257 U. S. 506, 514. See also *Maryland Casualty* v. *United States,* 251 U. S. 342, 349 and cases cited.

MR. JUSTICE SUTHERLAND delivered the opinion of the Court.

During the year 1916, respondent, as lessee, was in possession of and operating certain railroads and branches in New Jersey and Pennsylvania. The leases were for terms of 999 years and bound respondent to maintain and keep the leased property in good order and repair and fit for efficient use. Each provided that in the event of a default in that respect the lease might be terminated by the lessor. At the same time, respondent had leases of certain piers from the City of New York for various terms with the privilege of renewal, not to exceed in any case 30 years in all. One such lease required respondent to acquire and pay for the interests of private owners in an old pier and to construct a new one in its place. It provided that, if the cost should be less than $2,750,000, respondent was to pay in addition to rent 5½% on the

difference between that amount and the actual cost; but if the cost should be more than $2,750,000 respondent was to be credited on its annual rental with 5½% on such difference for 39 years, in which event the term was to be extended under a formula not necessary to be repeated. Respondent agreed to maintain the premises and structures thereon, or to be erected thereon, in good and efficient repair. The city was authorized to terminate the lease at any time after 10 years, but in such case agreed to pay to respondent such reasonable sum as might be fixed by arbitration. Other leases required respondent to do such dredging as the commissioner of docks considered necessary, and still others, to build extensions to the leased piers. All the leases provided that the city could terminate them if respondent failed to pay rent or failed otherwise to observe the covenants or agreements.

In the year 1916, respondent expended, under the railroad leases, for additions and betterments and, under the pier leases, for the several purposes therein set forth, the aggregate sum of $1,659,924.33, of which $1,525,308.72 was for the acquisition of the private rights in the old pier and the construction of the new one.

In submitting its income tax return for that year, respondent sought to deduct these various expenditures from its gross income under § 12 (a) of the Revenue Act of 1916, c. 463, 39 Stat. 756, 767–769, which provides, in the case of a corporation, that annual net income shall be ascertained by deducting from the gross amount thereof, among other things,—

"First. All the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity."

The collector refused to allow the deductions, and respondent, under protest, paid the amount of the increased assessment due to such refusal, and brought this action to recover it. Its contention is that the expenditures were "rentals or other payments" within the meaning of the provision above quoted, and that the whole amount constitutes an allowable deduction for the year 1916. On the other hand, the government contends that the disbursements were capital expenditures and that the only permissible deduction is an annual allowance under § 12 (a) subd. Second, 39 Stat. 768,[1] for "depreciation"; but, if the expenditures are to be regarded as additional rentals or other payments within the meaning of § 12 (a) subd. First, the amount must be prorated, under a regulation of the Treasury Department, over the life of the improvements or the life of the lease, whichever is the shorter. The federal district court gave judgment for respondent, which was affirmed by the circuit court of appeals, 289 Fed. 354; and the case is here on certiorari. 263 U. S. 693.

Clearly the expenditures were not "expenses paid within the year in the maintenance and operation of its [respondent's] business and properties;"[2] but were for

[1] Second. All losses actually sustained and charged off within the year and not compensated by insurance or otherwise, including a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business . . . *Provided*, That no deduction shall be allowed for any amount paid out for new buildings, permanent improvements, or betterments made to increase the value of any property or estate, and no deduction shall be made for any amount of expense of restoring property or making good the exhaustion thereof for which an allowance is or has been made: . . .

[2] Perhaps a critical analysis of the detailed statement found in the record might reveal items of minor importance which are of this character, or which might be classed as "rentals or other payments"; but since no point appears to be made in respect of such a differentiation we do not consider it.

additions and betterments of a permanent character, such as would, if made by an owner, come within the proviso in subd. Second, "that no deduction shall be allowed for any amount paid out for new buildings, permanent improvements, or betterments made to increase the value of any property, etc." They were made, not to keep the properties going, but to create additions to them. They constituted, not *upkeep,* but *investment;*— not maintenance or operating expenses, deductible under subd. First, § 12 (a), but capital, subject to annual allowances for exhaustion or depreciation under subd. Second.

Nevertheless, do such expenditures come within the words "rentals or other payments required to be made as a condition to the continued use or possession of property?" We think not. The statement of the court below that it was conceded by both parties that the expenditures were "additional rentals" is challenged by the government and does not seem to have support in the record. The term "rentals," since there is nothing to indicate the contrary, must be taken in its usual and ordinary sense, that is, as implying a fixed sum, or property amounting to a fixed sum, to be paid at stated times for the use of property. *Dodge* v. *Hogan,* 19 R. I. 4, 11; 2 Washburn, Real Property (6th ed.) § 1187; and in that sense it does not include payments, uncertain both as to amount and time, made for the cost of improvements or even for taxes. *Guild* v. *Sampson,* 232 Mass. 509, 513; *Garner* v. *Hannah,* 13 N. Y. Super. Ct. 262, 266–267; *Bien* v. *Bixby,* 41 N. Y. Supp. 433, 435; *Simonelli* v. *Di Errico,* 110 N. Y. Supp. 1044, 1045. Expenditures, therefore, like those here involved, made for betterments and additions to leased premises, cannot be deducted under the term "rentals," in the absence of circumstances fairly importing an exceptional meaning; and these we do not find in respect of the statute under

review. Nor do such expenditures come within the phrase "or other payments," which was evidently meant to bring in payments *ejusdem generis* with "rentals," such as taxes, insurance, interest on mortgages, and the like, constituting liabilities of the lessor on account of the leased premises which the lessee has covenanted to pay.

In respect of the 999 year leases, the additions and betterments will all be consumed in their use by the lessee within a fraction of the term, and, as to them, allowances for annual depreciation will suffice to meet the requirements of the statute. In the case of the pier leases, the improvements may and probably will outlast the term, and, as to them, deductions may more properly take the form of proportionate annual allowances for exhaustion.

The judgment below cannot be sustained except for $37,781.54, the amount of a conceded overpayment, with interest thereon as allowed by the trial court.

Judgment reversed and cause remanded with instructions to modify the judgment in conformity with this opinion.

DUFFY, COLLECTOR OF INTERNAL REVENUE *v.* CENTRAL RAILROAD COMPANY OF NEW JERSEY.

CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

No. 129. Argued March 13, 16, 1925.—Decided April 13, 1925.

1. Expenditures made by a corporate lessee, as required by the lease, to create additions to the leased property and not for upkeep, are not maintenance and operation expenses deductible from its gross income of the tax year in which made, within the meaning of § 12 (a) Subd. "First," of the Revenue Act of 1916, but are betterments under Subd. "Second" of that section,—capital investment, subject to annual allowances for exhaustion or depreciation. P. 62.
2. Neither are such payments for betterments and additions, though made by the lessee pursuant to the lease, deductible under § 12 (a), Subd. "First" as "rentals or other payments" required to be made as a condition to the continued use or possession of